

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Ted Truman to Secretary Rubin & Deputy Secretary Summers re: Dan Zelikow in Brazil (2 pages)	02/09/1999	P1/b(1)
002. memo	Daniel Zelikow to Assistant Secretary Truman re: Reflections on Brazil Trip (4 pages)	02/09/99	P5
003. notes	re: Meeting with Fund Mission Team (2 pages)	c. 1999	P5
004. notes	re: Meeting with Arminio Fraga, Ministry of Finance (3 pages)	02/04/99	P5
005. notes	re: Meeting at Finance Ministry with Finance Minister Pedro Malan, Pedro Parente, & Amaury Bier (3 pages)	02/05/99	P5
006. notes	re: Meeting with Think-tankers (1 page)	c. 1999	P5
007. notes	re: Notes from Meetings at Central Bank (3 pages)	c. 1999	P5
008. memo	Robert E. Rubin to POTUS re: Economic issues for State Visit of Jiang Zemin (2 pages)	c. 1999	P1/b(1)
009. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in China (1 page)	01/15/98	P1/b(1)
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### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [25]

Jimmie Purvis

jp23

### RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

### **Meeting with the Fund Mission Team**

1. **BOP:** IMF staff revised their BOP calculations slightly, with the current account worsening by around \$2 billion, the capital account improving by less than \$1 billion, and the external financing gap widening from \$10 billion to \$11.3 billion. A quarterly breakdown retains the previous path, with large external financing requirements in the first half (\$14.2 billion) with financing surpluses in the second half (\$2.9). Once we are back in Washington, a more detailed comparison with our numbers and the Fed's will be provided.
2. **FISCAL:** Teresa indicated that the Brazilian authorities are using overly-optimistic assumptions both on the primary balance calculation (3.0-3.5 percent of GDP surplus) and on the real interest rates (10.5% yearly avg) and that the IMF team was still in the process of reconciling these numbers for the program. Specifically:
  - A. Fund staff estimates show a primary surplus of 2.2% (based on identified additional measures such as oil price increase, postponing the first installment of the 28% court-mandated back-pay to civil servants, cutting rebates that had been given to exporters to compensate them for cascading taxes. (These were measures already mentioned to us by Malan.) As such, to reach 3.0% (a minimum, according to Teresa, who would prefer 3.5%) there would need to be 0.8% undertaken by the states and the public enterprises. This is highly doubtful to occur.
  - B. Any increase in the real interest rate assumption would deteriorate the overall balance by raising interest payments. Along with Teresa, we have serious doubts as to whether the interest rate assumption is consistent with the exchange rate assumption. Teresa suggested that if the central bank does not raise interest rates soon and substantially, the exchange rate will depreciate and the program will need to be re-estimated based on an average exchange rate lower than the currently assumed R\$165/\$.
  - C. Fund staff seemed to support the idea of setting the minimum wage increase now, before the price increases from oil and from the devaluation really take place. They acknowledged that it would only postpone the effect for one year, at which time a large increase would have to take place. But at least it might buy us some time.
  - D. On the state level, there is very little room for improvement. Although they indicated that the states were not confronting balloon payments as we had been told by the private sector last night, many of the states do have seriously deficient fiscal positions.

- E. The central bank should have a new privatization calendar this coming week which will shed some more light on what is in the pipeline. Teresa said that she had not heard anything from the authorities on an accelerated and deeper privatization effort with respect to Electobras. In either case, privatization is a below-the-line item and will not effect the overall balance (it will, however, be a reduction in the debt load which, Teresa had told us earlier, was where the fund staff were focusing and where the private sector seemed to be placing their concerns).
3. **INTEREST RATES.** The Fund (Teresa and Stan) had been told that interest rates would be increased in the very-short run; this is consistent with Teresa's belief that interest rates need to be raised to shore up outflows. This is at odds with our discussion with Arminio, however, where he said that interest rates would remain at current levels unless there were signs of excessive inflation. Teresa indicated that the TBAN system needs to be eliminated, where the rate is hooked to the overnight rate with a penalty; if they want to have a floating exchange rate, they have to have freely moving interest rates.
4. **BANKING DATA QUESTIONS:** IMF staff has been working with the central bank during the course of the current mission to revise their data collection and dissemination process on banking data. They have deepened the coverage to look not only at more banks but also nonbanks. They examine 35 top banks interbank lines (\$22 billion outstanding), MLT non-bank registered (\$22 billion), and public sector MLT (\$4 billion). This yields \$48 billion out of total bank lending of \$60 billion—or 80% identified. A difficulty is that short-term debt is not registered and is therefore not tracked. Data on these bank claims will be available on a weekly basis (on Tuesdays). In general, the agreed with what the central bank had told us yesterday—that the corporates were very small and could essentially be ignored. We suggested that they generate a 1-2 page explanation of the monitoring system for the G-7 Board members to alleviate current fears.

**Meeting With Arminio Fraga**  
**Ministry of Finance**  
**Thursday, February 4, 1999**

The meeting with Arminio was productive and yielded a much more coherent understanding as to where the authorities hope to take Brazil in the short- and medium-term.

1. Monetary: Fraga informed us that the central bank would be targeting inflation, using interest rates and reserve requirements as tools to respond to unexpected increases in prices.
  - The goal is to have annual inflation in the mid-teens with annualized fourth quarter inflation running at 5%. Only the fourth quarter target is going to be announced anytime soon.
  - The assumptions underlying the inflation rates are: real growth of -3.5% (followed by positive growth in the two following years of +4% and +5%, respectively); an exchange rate of R\$1.65/\$ (or, equivalently, 40% depreciation with about a 40% pass-through). In the past, pass-throughs have been roughly 60%. With little indexation left, recession, benign inflation environment globally, and primary surpluses, Fraga felt that 40% pass-through was plausible.
  - Monetary policy would remain tight during the initial months, with nominal interest rates at roughly 40%—higher should inflation accelerate. After the initial turbulence has eased, Fraga feels that much lower nominal rates are possible with average real rates for the year around 10.5% [this strikes us as very low and depend on inflation in HI significantly higher than mid-teens].
  - At least initially, they will also set quarterly NDA targets to use as a nonbinding benchmark.
2. Central Bank Independence: The released this pm a communique that would greatly enhance central bank independence, including a bundesbank-like mandate for preserving the purchasing power of the real, an accountability to congress (including a regular Humphrey-Hawkins testimony), fixed terms for President and directors, and a cooling off period (or quarantine as they called it) of 6 months for top central bank officials from working in the financial sector upon leaving the central bank. The last is seen as the political price for getting Congress on board for the constitutional changes that will be needed to secure CB independence).
  - Fraga was unclear if this would need an amendment to article 192 but he thought it would (he is checking).
  - The goal is to have this in place by year's end.
3. Fiscal: Fraga recognized the importance of showing a declining and therefore sustainable debt stock path.

- Target a primary surplus of 3-3.5% of GDP. Inflation will help through a reverse Tanzi effect—we will try to get specific numbers from them and the Fund on this tomorrow.
- He indicated that the impact on devaluation would be 4% of GDP added to the debt stock, that the losses on the futures position would be stuck in the budget right away (the amounts weren't specified, though he did say that the PSBR could be as much as 10% of GDP this year).
- Fiscal measures: He sell excess shares in listed state companies, including Eletrobras (need to verify which were already included in the original program).
- He seemed extremely pleased with President Cardoso's agreement to take action on Banco do Brasil and Caixa Economica, a pet project of Fraga's. The first step, which will be announced within the next two weeks, will be an announcement of a commission to analyze the role of the two with a view toward making them more efficient and rationalized, including selling a strategic equity stake in Banco de Brazil. The analysis is to be done by September, and the sale will be done within 2 years). Fraga admitted that it would be a difficult sell in Congress, but he did not think it would derail outstanding fiscal steps such as the CPMF, which Cardoso insists is in the bag.
- He also said that new measures to achieve the primary surplus additions would be "real", and focused within the Federal Government on the expenditure side..

4. Program to Boost National Savings: In an effort to increase private savings in the longer term, they are considering:

- 2<sup>nd</sup> generation social security reforms
- pension fund reform (he sees Mexico and Chile as models)
- insurance sector reform: the sector is overly- and poorly-regulated, particularly the life insurance sector.
- SEC reform
- change current methods of taxation on investment
- other undisclosed measures

5. Exchange Rate Policy:

- Based on a BOP analysis, the central bank intends to sell foreign exchange each month
- Fraga indicated that, when the markets are thin and subject to manipulation, the central bank will intervene. This would be done with limits (say \$100m per intervention, with a monthly cap, and subject to volatility triggers). We expressed our concern about the discretion involved and the clouding of their free-float with an amount of discretion that probably wouldn't make much of a difference if there were a severe attack. Fraga was insistent that he needed at least some discretion to avoid manipulation so as not to leave himself defenseless, as the bank was last Friday.

- The central bank will be entirely out of the futures market after the expiration of their \$5 billion for next month. He wasn't so sure about Banco do Brasil's independent activities and wanted me to raise it with Malan.
  - Fraga intends to analyze the composition of their reserves to get a better indication of the level of junk reserves. He expressed dismay upon learning yesterday the amount of junk held, and said that when he took over the job of Vice President a few years ago, he inherited \$5b in junk of a total of \$16b. He left the Bank with no junk. That is a major objective of his this time too.
  - He noted that Bank's short position in FX market was now about \$1b in reais. He thinks that will have to be raised to make market work better.
6. Enhancements: Fraga expressed caution on any enhancements that would take the form of a guarantee because it could pollute their other debt. He wanted to discuss this more fully when we meet together with Pedro tomorrow.
  7. Investment Advisor: Fraga had been quite convinced about hiring an adviser but now wasn't so sure. He was concerned about the credibility of the adviser's role, given the Korea experience, and was worried that there'd be some bad-mouthing by firms not selected. He noted that they were already getting lots of proposals to raise money, even on his first day on the job.
  8. Foreign Financing: the external financing gap was still an open question and would require further analysis. He said he thought BOP numbers pretty good, but that we'd address this tomorrow together.
  9. Bank rollovers: He took point that there is very inadequate data on foreign bank credits to non-banks, and on the nature of the Bank-to-bank pass-throughs to the enterprise sector. He thinks the reduction of roughly \$10b in interbank lines so far essentially has run its course. He referred to a mapping exercise on the interbank /trade lines which was underway. This discussion was vague and not very satisfactory. Will pursue tomorrow.
  10. Transparency: Contrasting his view with Marcus, who was also at the meeting, he thinks the central bank has far to go to improve transparency. He will be focusing on this.
  11. Personnel: Referred to progress being made in building his new team. Paulo Leme agreed to join today, and will take Demosthenes job and will be leading the international financing effort and the roadshow presentations (can't think of a better person to do it). He's also got lined up a new research director and director of reserve/fx management, but hasn't got their sign-off yet to announce.
  12. Overall, he struck us as in command of his thoughts, if not yet all the details. He wants to make sure we're comfortable with the program because he needs our vocal support and support with the g7.

Will be meeting with Teresa first thing tomorrow morning, followed by a day of meetings being set up by Marcus.

**Meeting at the Finance Ministry**  
**With Finance Minister Pedro Malan, Pedro Parente, and Amaury Bier**  
**February 5, 1999**

***Fiscal:***

The authorities recognized that their significant lack of credibility is weighing on the markets and will need to be repaired for a reversal in capital inflows. As such, they expressed a strong recognition that they are unwilling to make false promises or unrealistic assumptions. That said, and of reaching a net debt to GDP target of 46.5% by 2001 (two year later than originally envisaged).

1) Primary Surplus Effects in 1999: they explained to us the constraints on further fiscal consolidation and the challenge of reaching a primary surplus of 3.0-3.5 percent in 1999.

A. There is little room for revenue enhancement, implying that new fiscal measures will most certainly need to come from the expenditure side. Measures being considered will not involve going to congress. These are:

- a. oil price increase;
- b. postponing the first installment of the 28% court-mandated back-pay to civil servants.
- c. cutting rebates that had been given to exporters to compensate them for cascading taxes. (this should make our congress happy).

B. They agreed with the Fund that there would only be marginal benefit from a reverse

Tanzi effect for several reasons:

- a. Social security benefits will increase with the minimum wage increase; the minimum wage is expected to be increased in May.
- b. The increased price of oil due to the devaluation will either erode the Petrobras surplus if wholesale domestic oil prices are not raised accordingly or will contribute to inflation and to pressures on the minimum wage hike. Although delaying a domestic price adjustment would push off the inflationary pressures, the authorities did not find this an attractive alternative (Stan Fischer also said to them that it was important to get the price hike in effect immediately to feed into the tradables).
- c. There will be tax evasion.

A. On the benefit side, the authorities have agreed to another year of zero wage increases in the public sector. BNDES also reports somewhat higher expectations in real terms for privatization receipts given the devaluation and foreign source of much of the sales

proceeds. This would only help below the line, of course. They also expect something more from electrobras acceleration, but don't have numbers yet.

- 2) Debt Stock: They are targeting a net debt-to-GDP ratio of 46.5% by 2001, two years later than originally envisaged by the IMF program. The devaluation is estimated to have increased the debt burden by 4-5 percent of GDP, including central banks futures losses.
  - A. The feasibility of the target is highly sensitive to assumptions on growth (-3.5 in 1999, +4 in 2000, and +5 in 2001) and on the real interest rate (10.5% average for 1999, single digit in 2000 and 2001). We are skeptical about these assumptions, particularly the real interest rate assumptions.
  - B. Increased privatization may occur in 2000-01 (relative to baseline) with Banco do Brazil and possibly Caixa and with Petrobras—all of which will need significant public debate to win political support. Banco do Brasil is anticipated to be completed by end-2000. Petrobras will not even be placed on the calendar in 1999 because of the political ramifications. They would begin with efforts to consolidate operations of Caixa and Banco do Brasil, but don't expect any cost savings in 1999.
  - C. Water and sewers are also being actively considered (will help state budgets, not federal); this requires a change in existing law, but they don't expect that to be difficult.

#### **Monetary:**

The Finance Ministry authorities reiterated what Fraga had told us the previous day, that the central bank would be targeting inflation with the use of interest rates as a tool and NDA targets as rough guidelines.

- 1) Real interest rates will initially be high, increase further as inflation begins to decline but before credibility has changed inflation expectations significantly, and then fall substantially—yielding an average real interest rate of 10.5%. They do not anticipate a need for an initial increase above current levels.
- 2) Although the authorities agreed that intervention should not be used to go against trends in the exchange rate, they tried to impress upon us the importance of have the flexibility to smooth thin markets; as justification, they cited two concerns:
  - A. "Black Friday," when the real fell to R\$2.15 per dollar, was viewed as market manipulation during periods of extreme thinness on the markets.
  - B. Evidence in other crisis countries illustrates the dangers of multiple equilibria
  - C. Would feed market a certain amount of reserves based on analysis of BOP gap.
- 3) M0 shows is relatively inelastic to changes in the interest rate; reaction to interest rate changes could be slow. Need some sort of moving average.



***Bank Data Issues:***

- 1) Bank-on-bank data should be available in detailed form from the central bank. Bank-on-corporate data was being prepared, although the exposure was extremely limited in this category. (We spoke to the central bank about this and informed us that detail data was available and had been sent to the IMF for some time now).

***Enhancements:***

The Ministry of Finance indicated that there were differing views on MDB enhancements. Fraga, in particular, was apparently opposed to the idea while Amaury was much more willing to accept the idea that enhancements would not damage future debt placement.

## Meeting with Think-tankers

1. Big vulnerability on ability to contain inflation is the decision on setting the minimum wage, which is normally done on May 1<sup>st</sup>. The issue is the rule used rather than the level, as the rule is typically replicated extensively by the private sector. The direct impact is fiscal in that social insurance payments are keyed off the minimum. They have the legal/technical latitude to set a minimum with no increase, despite the constitutional mandate to preserve the real value of the minimum wage. However, given Cardoso's uneven support, especially among the poor, and the fact that Cardoso himself must set the minimum wage, not clear if he will be able to withstand the political pressure for raising it.
2. Another vulnerability on fiscal stems from intergovt fiscal relations. The ability to withhold constitutionally mandated transfers is a powerful weapon but may not be sufficient. First, there are several law suits, sanctioned by state supreme courts, that prohibit the Feds from withholding transfers. Not clear what the Fed Supreme Court will decide, and a decision is expected very soon. Second, legal challenges will continue and will be affected more by the political context than by the law. Third, the mandated transfers are actually a relatively small proportion of the biggest states' budgets, which is where the main problems lie. The smaller states, which could be bludgeoned into compliance, are doing so anyway. Fourth, it is a fact that some of the big states are not financially viable under the terms of the debt deals they worked out with the Feds in 1995. They agreed to balloon payments which can't be met without politically infeasible reductions in state services. Yet it will be extremely difficult to restructure the debts of these states without opening the pandora's box of the others' debt deals. Fifth, there is the political context of local elections coming up in October 2000, which will start to weigh on governors' decisions.
3. Another bit of bad news coming down the pike are the decisions by the governors of Minas and Rio Grande do Sul to rescind the very rich tax incentives proffered foreign investors in carm manufacturing to locate in those states. In one case, Mercedes has already built a big plant. Expects this to become public in 10 days and a very adverse reaction from foreign investors who will question durability of their incentives too.
4. Skepticism about IMF program's assumptions. Informed people don't believe the nominal deficit targets or inflation projections. There is also concern that IMF is more focused on making Brazil work in its narrow definition to restore its reputation than the economic health of the real sector.
5. Appreciation for Treasury's role in assembling package. Thinks we should become more active, but behind the scenes. Noted that our visit was carried on national television yesterday. We appeared to be checking up on IMF, however, not Brazil, given the imminent joint press conference with Stan., which itself was considered highly unusual. Wants us to continue urging full implementation.

## Notes from Meetings at Central Bank

Meetings attended by Gustavo Bussinger (DepHd of Economics), Maria do Socorro (Hd of International Reserves), Head of Trade Finance Dept, Alvir Hoffmann (DepHd of Supervision Dept), and chaired by Demosthenes Madureira, Acting President.

1. On monetary and xrate policy: As you might expect, Demosthenes and Bussinger wouldn't be drawn, deferred to my earlier meeting with Arminio, and said that Arminio and economic team would decide. D. did proffer a somewhat sympathetic view to a non-discretionary intervention rule, suggesting that the instrument of intervention, if tightly regulated, may not be worth the loss of purity. On the other hand, he drew the distinction with Mexico's non-intervention rule as citing the absence of reserves in the latter situation which made intervention not practicable from the get-go. In general, they demonstrated a high degree of familiarity with the Mexican put scheme and auctions, for example, by noting that Mexico put in place the put scheme only in August 1996 and the auctions in January of 1998. They evidenced a real sense of trauma (as did the finance ministry) about the events of last Friday when the real saw no floor.

2. On the BOP. Noted that the BOP was currently being revised, so didn't have updated estimates. On a preliminary basis, projected a shift in the trade account of +\$10b, assuming an xrate of 1.60-1.70. At 1.80, estimated an additional shift of \$1.2b-1.8b. Expected the CA deficit at the more appreciated rate to come in at \$20-22b in 1999, representing 2.6-2.8% of GDP. Expected very short lags on the trade accounts (3 months or so for the adjustment to occur), but much longer lags with interest and services. The whole CA would also be subject to strong seasonal patterns, with a widening impact in QIV.

3. On financial vulnerability of the private sector. Cited absence of any vulnerability to devaluation of banking sector because system only \$1b short now, and was long \$s at time of greatest depreciation. Because the crisis had been "pre-announced", banks had cut back their exposure to vulnerable borrowers in advance. More on this below. In the real sector, the picture isn't as clear. They believe that the private sector as a whole is well hedged and well-capitalized. And most of the largest firms have a natural hedge with exports. They infer these conclusions from the sharp drop off in utilization of the futures market (implying lower demand rather than supply), and ready availability of dollar-indexed govt securities, though others noted the longer tenor of these bonds rendering them less suitable for hedging purposes, which makes me think they're not so sure.

4. On domestic debt restructuring. Left me with the impression that this would be last resort (after inflation). Noted near-total ownership by domestic participants, and 50+% ownership by domestic banking sector. Because 70% of banking system assets are govt securities, this would achieve little fiscally and destroy the domestic banking system in process. Cited bank runs last Friday as attributable to fears of debt restructuring, precipitated by Menem statement and front-page editorial (an unusual event) of a major Sao Paulo daily calling for restructuring. People still singed by experience of bank asset confiscations under Collor, so this was really a domestic capital flight into real cash, not a flight into dollars.

5. On bank monitoring. Here was the big surprise, that doesn't reconcile with what we heard in Min Fin and from IMF. Elaborated on the monitoring system in a way that suggested that they know the external liabilities in huge detail of on-shore and off-shore Brazilian banks, by type of credit and terms. Say they've refined system considerably since program began and that the nature of the system is well known by IMF staff (though apparently not by TERESA). Also said that virtually all trade finance is done through the banking system, and that virtually all external credits to the real sector are capital market transactions (for which they also have the data) or suppliers credits or intra-company loans. I told them that this was at great variance to what we have been told by others and that there is a big data inconsistency between BIS data, monitoring system data, and BCB web site data. They seemed to acknowledge this but said IMF has the reasons why. Mentioned a fellow named Alberto from the IMF team who has been working closely with them. I told them they should write a paper explaining the system qualitatively to the IMF Board to illuminate these issues, to which they agreed. I also suggested that creditor country ignorance of the data could be better dispelled by inviting G7 central bank reps to work in the BCB on the system with them, to which Demosthenes readily agreed (easy for him to do so, of course). Expressed some concern that IMF wouldn't agree. TERESA, however, told me she thought it was a good idea. **YOU MIGHT WANT TO RAISE THIS ON THE G7 DEPS CALL.** D also noted the very encouraging rollover numbers of 25th-29th Jan (93.5%) and said that the export finance component of the lines seems to be recovering, following a very erratic January.

6. Banking system. Seems very solid, from what I was told. In general, said the system has well adjusted from loss of huge income (\$9b) that resulted from their use of the float in inflationary days. Also cited restructuring that has occurred in past few years, improved legislation that gives them significant powers of persuasion, and a sophisticated credit risk bureau at the BCB that is in place for all credits above R50,000. Since the Asia crisis, system has been much more selective on credit extension, and the proportion of banking system assets represented by loans is now only 30%. System is well hedged on interest rates, duration and fx. By regulation, capital asset ratios must be 11%. In fact, the system is at 19%, and the top 50 banks at 15.3%. Domestic private banks are at 25.6%; foreign banks are at 20.2%; and JVs are at 17.9%. The big banks that drag down the averages are the public sector banks, both State and Federal. Provisioning for bad loans as of Nov 98 are also very high, representing 10.78% of total credits, v. 2.22% of overdue loans and 7.4 % of loans rated as impaired. The loan performance reporting period is 60, rather than 90 days, and the entire loan is counted as impaired, not just the component in arrears, as is the case with several other Latin countries. They're not very worried about deteriorating portfolio quality on systemic health of banking system. Noted recent IMF stress tests indicating that if NPLs rose by 50%, just 7 banks would fall below statutory net worth. If NPLs rose by 100% and system had 0 profits, just 9 would fall below net worth minimum, and most of these are state-owned. [He didn't indicate what proportion of banking system these represent]. He doubted that NPLs would rise by all that much,, as interest rates have been high for a long time in a slow-growth environment, and most borrowing is done by blue-chips and very profitable businesses. Banks are well hedged to fx risk. Of system assets, R109b are dollar-linked. The system has R103b in dollar-linked liabilities. Moreover, the banks have \$10b in net worth in foreign assets overseas. He's also not worried by a withdrawal of foreign bank credits. Thinks foreign banks are doing quite a lot of intra-firm credit extension, and the rest care a lot about protecting their market share

in Brazil. Said much of the roll-off of lines so far attributable to exchange rate uncertainties that are much diminished [this strikes me as way too optimistic]. Consumer credit businesses are relatively small share of lending portfolios. Moreover, the bankers' association operates an effective credit information bureau that forces consumers to pay back before they can hop to another institution. The main risks in the financial system are to be found in the leasing business. This represents, however, only \$12b in banking system assets (of a total portfolio of \$200b+), and the rest of the leasing businesses (\$14b) are mostly foreign-owned, especially the captives of the car companies, which all have strong foreign parents.

7. US EXIM Trade Finance. At Jim Harmon's request, I raised issue of restrictions on short term trade finance that Brazil has operated since march 1997 to curtail interest rate arbitrage that was occurring by blue chips under guise of trade finance. These restrictions (which forced settlement up front) effectively preclude exim from doing short-term private sector business in Brazil and the activation of the \$1b program Jim announced last week. They were aware of the problem and are working out the mechanics of changing the regs so that they can gain access to the trade finance insurance which they genuinely want. Maria warned however that the solution, though relatively easy, involves some complex issues which they will need to bring Arminio up to speed on. She said that the process of finding the solution and educating arminio should require about 3 weeks to fix the problem. PLEASE PASS THIS MESSAGE ON TO MEG AND STEVE TVARDEK.

8. Process and data sharing. Gustavo Bussinger insisted that he was now faxing the daily monetary numbers to Wes, and was surprised to hear that wes wasn't yet receiving. He also said that he would now be DHLing the Indicadores weekly to Wes, and he agreed to share more disaggregated bank-line data too. He asked that all of this be regarded as confidential. Maria apologized that she hasn't been in touch with Wes. She explained that for the sake of bureaucratic convenience and harmonizing the central bank message to us, they have designated Gustavo as the sole interlocutor with us for data sharing issues. I said that this was in itself not a problem, but that gustavo should designate an english-speaker on hiis staff who could be readily reached should he not be. He was concerned that that person wouldn't have the breadth of knowledge that he has so might not be effective. I said it would still be preferable to the delays associated with trying to reach a very busy person. He said he'd find someone. He also noted the very cordial relationship he has developed with wes, which i confirmed from the other side.

January 15, 1998  
Seoul

**Fax from:** Lawrence H. Summers  
Deputy Secretary to the Treasury

**To:** Sandy Berger  
National Security Council

**cc:** Erskine Bowles  
Secretary Rubin  
Secretary Albright

**Re:** Read-out from meetings in Hong Kong

Met with C H Tung, the Chief Secretary and the Head of the Hong Kong Monetary Authority. There was a sense of apprehension but not imminent panic around the Asian financial crisis. Great amount of anxiety about US Congress, Fast Track, IMF etc. Surprising amount of conflict between Monetary Authority and government, as illustrated by government's great desire to find ways to defend the peg without increasing interest rates.

Policy position is to accept dollarization in extremis rather than abandon the peg. Serenity about Peregrine. Convincing denial about Chinese interference with the peg. Not totally convincing in optimism that Chinese peg will hold, and recognition that fall of the peg would be calamitous. Bothered but not conspiratorial about Taiwan devaluation. Full of complicated but not compelling schemes, first raised in Manila, to marshal new sources of international official finance and develop domestic bond markets in Asia.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Your Dinner with German Chancellor Kohl (2 pages)	06/04/97	P5
002. briefing paper	re: Russian Financial Issues (2 pages)	ca. 1999	P5
003. memo	Robert E. Rubin to POTUS re: Meeting with German Chancellor Schroeder (3 pages)	02/09/99	P5
004. memo	Robert E. Rubin to POTUS re: The Economic Agenda for the Lyons G-7 Summit (4 pages)	06/24/96	P5

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 24126

### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [28]

Jimmie Purvis

jp25

### RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

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## **Russian Financial Issues**

Prime Minister Primakov's government continues to move slowly on economic issues to not jeopardize the current political stability. Given Yeltsin's poor health, Primakov appears focused on building bridges to the Duma and Federation Council. So far, Primakov has enjoyed some success. His more accommodating relations with the Duma and its continued opposition to key economic reforms reflects a fundamental lack of consensus among competing political groups. This has led to ongoing political maneuvering, which is likely to continue before legislative elections in December and a presidential election scheduled for June 2000.

Since the Russian government's decision on August 17 to devalue the ruble and default on government debt, the Russian economy has slumped badly:

- inflation has jumped--prices rose by over 11% in December and 8% in January,
- output has fallen--GDP was down about 5% last year overall,
- the ruble has dropped by about 75% to 23 R/\$,
- imports have plummeted by 40-50% while exports are down slightly due to low oil prices,
- the banking system has fallen largely into insolvency, and
- Russia has missed payments on domestic debt and foreign debts to the Paris and London clubs.

Budget: Russia's budgetary failings lie at the heart of the financial crisis and still remain to be addressed. The Duma passed the government's draft 1999 budget in the final reading on February 5 after making only minor changes. The budget calls for a deficit of only 2.5% of GDP, but it is based on unrealistic assumptions about inflation, the exchange rate, and revenue collection. The budget also contains few funds for bank restructuring or the clearance of wage and pension arrears. The budget will now be reviewed by the Federation Council, which may object to provisions regarding the distribution of revenue between the center and regions.

IMF: The IMF has consistently told the Russian government that the draft budget needs serious adjustment. An IMF team was in Moscow from January 22-February 5, but made only limited progress in discussions with Russian officials. The Russian government plans to provide additional proposals to the IMF this week and it has invited the IMF to return to Moscow in mid-February. It is unclear how long this process will drag and whether the Russian government will develop the appropriate sense of urgency.

If the IMF and Russia can reach an agreement on a new program, it would open up the doors for additional support. The World Bank will not consider new adjustment lending to Russia until a macroeconomic program backed by the IMF is in place. Japan's Ex-Im bank is prepared to release a loan to Russia that is tied to World Bank support. In addition, Russia's Paris Club creditors will consider restructuring Russia's debt only after Russia has an agreement with the Fund.

Debt: Russia is in arrears to Paris Club creditors on roughly \$1B in debt, largely owed to Germany. Russia has also not paid \$362M to London Club creditors, who declared Russia to be in default. Russia also defaulted on large amounts of domestic ruble debt (GKO's). Russia has



recently issued new bonds to exchange for the defaulted ruble debt. Most foreign investors, however, have refused to exchange their ruble debt because they are holding out for more favorable terms. Russia continues to make payments on its debt to the international financial institutions, on Eurobond interest, and on official debt to Paris Club countries contracted since the breakup of the USSR. Altogether, Russia plans to pay \$9.5B of the \$17B in foreign debt that it owes this year.

Reserves: Russia had \$11.6B in foreign reserves, including gold, at end-January. The Central Bank (CBR) has required Russian exporters to sell 75% of the export revenues in markets controlled by the CBR. Many exporters, however, are evading this requirement. The ruble has stabilized in recent weeks at about 23 R/\$, but traders expect a continued slide throughout the year.

Banking: The Central Bank has developed a reasonable plan for the restructuring of the banking system, but it has failed to make much progress in implementing the plan. While the CBR has provided credits to only a limited number of Russian banks, these decisions appear to be made for political reasons. In addition, the CBR lacks the legal authority to take over insolvent banks. Lack of government action on bank restructuring has allowed owners of failed banks to strip their banks' remaining valuable assets. This will significantly increase the ultimate costs of the banking crisis to the government, depositors and creditors.

#### Suggested Points

- G-7 needs to pursue consistent theme with Russian government. Our message remains the same: it is in Russia's long-term interest to stay on the path of reform and integration, not isolation and state control. Secretary Albright and VP Gore each gave this message to Primakov in recent meetings.
- We all want to find ways to support the Russians. But, a sustainable budget and a workable IMF program are necessary or else international assistance would be wasted -- again.
- G-7 needs to give consistent message to Russian government that IMF will not lend for political reasons. Russia needs to engage in serious discussions with IMF. So far, the Russian government has not shown sufficient willingness to work with the Fund on technical issues.
- The U.S. has consistently told the Russian government that an agreement with the IMF is needed before Russia can begin discussions with the Paris Club on debt restructuring. Until then, the G-7's joint approach of not declaring in default in the Paris Club is appropriate.
- When/if the time comes for the Paris Club to consider a restructuring of Russian debt, it will be important for the U.S. and Germany to consult closely to develop a reasonable restructuring proposal.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Update on Mexico's Stabilization (3 pages)	05/15/95	P5
002. briefing paper	re: Why Should We Advance the US-Mexico Economic Relationship? (3 pages)	09/19/95	P5
003. talking points	re: Talking Points for Call to Ortiz (2 pages)	10/25/95	P5
004. memo	Lawrence H. Summers to POTUS re: An Update on Mexico's Economic Performance & Challenges in Advance of President-elect Fox's Visit to Washington (2 pages)	08/23/00	P5

### COLLECTION:

Clinton Presidential Records  
Clinton Administration History Project

OA/Box Number: 24124

### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [4]

Jimmie Purvis

ip33

### RESTRICTION CODES

#### Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

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TO Dan -

9/19/95

1995-SE-150151

This is getting done. Why can't we have the 1992 debt crisis stuff 9/11  
from the Rubin testimony attributed to NAFTA and fin. support? Why  
can't we have any immigration, Mexican collapse stuff. Have we no  
Why Should We Advance the US-Mexico Economic Relationship? *keats of export growth to maxi*

↓  
*Are we in the gray working on this? Lets move.*

**BRIEF:** Viewing the events of 1995, critics claim that Mexico's financial difficulties prove NAFTA was a mistake and that we should build walls -- not bridges -- to Mexico. The facts prove the exact opposite. Mexico's financial difficulties and their threat to American exports and jobs would have been far greater without the protection that NAFTA and U.S. financial support affords us. Both preserved economic reforms that have kept Mexican markets open to our goods. Both have bolstered investor confidence, preventing the threat to other important U.S. export markets while maintaining exports to Mexico at levels higher than otherwise might have been. Even with Mexico's present difficulties, United States exports to Mexico, and the U.S. share of all of Mexico's imports, are still higher -- not lower -- today than they were before NAFTA in 1993. Most important, Mexico's economic fundamentals and the opportunities Mexican economic growth presents to the United States are far better than ever before -- because of the closer economic relationship our two countries have forged.

*Leaving 95-150151*

- **Mexico's financial crisis and the current recession it created had nothing to do with NAFTA. Rather, it resulted from Mexico's pursuit of unsustainable macroeconomic policies.**
    - Mexico's economy is in better -- not worse -- shape than it would have been without NAFTA and our financial support. NAFTA locked in trade and investment liberalizing measures that are essential for Mexico's continued economic progress. Our 1995 agreements preserved these reforms and extended them.
    - Our economic ties help to ensure that temporary difficulties will not lead Mexico to retreat from continued pursuit of fundamental economic reforms, including market-opening measures and privatization. In 1982, Mexico reacted to its financial crisis by retreating to protectionism, stalling growth for a decade. By contrast, in 1995, Mexico pushed reforms forward with even greater vigor.
    - Reforms undertaken already and accelerated in 1995 have left Mexico's economy with better fundamentals to sustain growth than ever before.
  - **The best test of an agreement is how it works in bad times. We now see that the U.S.-Mexico economic relationship has protected American jobs and exports to Mexico from the effects of Mexico's financial crisis, because it committed Mexico to keeping its market open to our goods. We would have been in far worse shape had a crisis erupted without the insurance that NAFTA provides and the cushioning effect of our financial support in 1995.**
    - Mexico's commitments to the United States under NAFTA have protected the United States from tariff hikes and other trade restrictions that the Mexicans have imposed on others.
- Just*

- Since NAFTA, Mexico has lowered its tariffs on U.S. products by 4.4 percent. And while in the face of crisis, Mexico raised tariffs on non-NAFTA partners by 15 percentage points on some goods. On January 1, 1995, in accordance with NAFTA provisions, Mexico cut its tariffs on U.S. imports.
- In fact, in response to our financial agreements, Mexico has gone beyond its NAFTA obligations in its liberalization of financial services and in its extension of privatizations -- thus, creating new opportunities for American firms and workers.
- That is why, in spite of Mexico's difficulties, our exports to Mexico over the first half of the year were 2.5 percent greater than they were in the first half of 1993, before NAFTA was adopted.
- And, while all Mexican imports have fallen temporarily due to the financial crisis, the U.S. share of Mexican imports increased from 69.8 to 71.6 percent over the first four months of 1995, compared to the same period in 1994.
- Our experience this year stands in sharp contrast to 1982, when the Mexicans slapped 100 percent duties aimed at American products and workers, a move that sliced our exports to Mexico by 50 percent and took more than six years to recover.
- Most analysts expect Mexico to resume economic growth next year, and to continue as the fastest growing major export market.
- **The U.S.-Mexico economic relationship has bolstered investor confidence in Mexico. That has helped contain the effects of Mexico's crisis and avert serious threats to U.S. prosperity and jobs.**
  - With NAFTA in place and President Clinton's bold action to help Mexico face down its crisis, investor confidence has returned quickly. This stands in stark contrast to 1982, when Mexico retreated into protectionism and struggled for years to attract the foreign investment it needed to grow.
  - Our strategy has prevented Mexico's difficulties from spreading to other emerging economies. These emerging markets are our fastest growing export markets -- supporting some 4 million U.S. jobs, preventing another "lost decade" of economic opportunities in the Hemisphere.
  - These exports will make an important contribution to building a fully employed, high-wage, and even more prosperous America. For example, American workers that are employed in export-producing jobs

have wages that are 13-17% higher than the U.S. national average.

- **Most broadly, Mexico's own strong reform efforts and our commitment to support them has placed Mexico on the path toward becoming the most dynamic of America's largest trading partners. If Mexico had remained a closed market, it would always be a cheap-labor competitor, and a source of poverty and tension along our 2,000- mile border for the foreseeable future.**
  - Despite the crisis, Mexico is continuing to lower trade barriers, as required under NAFTA, and should eliminate all tariffs on U.S. goods by the year 2009.
  - Despite the crisis, Mexico is embarking on a new and deeper round of privatizations, generating further growth and opening up opportunities for American companies to *expand*.
  - In the long run, a strong, stable, and prosperous Mexico is critically important for both our countries. That is the only way for both our nations to reap the benefits that trade, commerce, and stability across our borders can afford.

October 25, 1995

# TALKING POINTS FOR CALL TO ORTIZ

- o I am troubled by Hacienda's press statement today for reasons of substance and process.

## Substance:

- o We are taking heavy political hits for the rollovers of the short-term swaps, including a "Sense of the Senate" (non-binding) resolution calling for your immediate repayment, and public attacks by D'Amato that allege misrepresentation of your progress.
- o We've carefully crafted a strategy to deal with our critics, and, to be effective, this involves judicious and appropriately timed communications to the Congress and the press.
- o Hacienda's statement today complicates matters and is actually incorrect: Bob had not yet taken the formal decision to roll over the swaps [though he since has], and it is certainly not Mexico's place to announce a decision by our Secretary that we have yet to do.

## Process:

- o Perhaps more troubling, my staff, at several levels, had explicitly advised yours of these facts and told them not to make the statement you did, explaining the reasons why.
- o In fact, Zelikow had worked out with Martin Werner a statement that you could release, in Spanish, that Martin had agreed would work for your purposes (to calm the markets about the D'Amato problem). By the time Zelikow got off the phone, however, your erroneous release had come out.
  - either Zelikow was being humored by Werner or there is inadequate coordination within your ministry with your spokesman.
  - it would not be for the first time, whichever the case.
- o Jeff Shafer called Werner back to complain and said to issue a correction, along the lines that Zelikow and Werner agreed. We still haven't seen it on the wires.

**Conclusion:**

- o I appreciate why you may have wanted to issue a statement, but, when it comes to our program, I must insist that you contact us first and respect our views.
- o If this was an error by your spokesman, it is just the latest in a long line that we have brought to your attention. His performance undermines yours and damages our mutual efforts. The problem should be corrected once and for all.
- o If this error was caused by a lack of respect for the objections of my staff, let me assure you that, pending a reversal by me, they speak on my behalf.
- o I hope that we can agree that an episode like this will not be repeated: it damages the excellent working relationship that our two ministries have enjoyed, as well as the trust that is essential for our joint efforts to succeed.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence H. Summers to POTUS re: Strategic Petroleum Reserve (2 pages)	09/13/00	P5
002. memo	Lloyd Bentsen to POTUS re: Russian Economic Reform & the Washington Summit--Building Economic Partnership (5 pages)	09/26/94	P5
003. memo	Lawrence H. Summers to Secretary Bentsen re: Memorandum to the President on Russian Economic Reform & the Washington Summit (1 page)	09/23/94	P5
004. memo	Lloyd Bentsen to POTUS re: Ukraine: Economic Reform & the Kuchma State Visit (3 pages)	11/18/94	P5
005. memo	Robert E. Rubin to Vice President Gore re: Economic Themes for Upcoming Visit of Ukrainian Prime Minister (1 page)	09/21/95	P5
006. briefing paper	re: Current Economic Situation in Ukraine (2 pages)	circa Sept. 1995	P5
007. memo	Robert E. Rubin to Vice President Gore re: Gore-Chernomyrdin Commission Meeting (1 page)	01/11/96	P5
008. memo	Under Secretary Shafer to Secretary Rubin re: Proposed Meeting with Russian Prime Minister Viktor Chernomyrdin (1 page)	circa Jan. 1996	P5

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [5]

Jimmie Purvis

jp34

### RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

Freedom of Information Act - [5 U.S.C. 552(b)]

- P1 National Security Classified Information [(a)(1) of the PRA]
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- RR. Document will be reviewed upon request.



## CURRENT ECONOMIC SITUATION IN UKRAINE

Until the middle of the summer, Ukraine was on track with its stabilization program and had made real progress reducing inflation. The budget was on target (deficit = 3.3% of GDP) and monetary policy remained relatively tight, despite large capital inflows. Monthly inflation fell from 21% in January to 4.8% in June, and the exchange rate remained steady for most of the first half of 1995.

Despite stabilization progress and evidence that the large informal economy (~40% GDP) was growing, a recovery in output and trade was not immediately evident in official statistics, and the leadership has been showing signs of "reform fatigue". Questions about Ukraine's reform commitment arose in July due to three major developments. First, President Kuchma gave a controversial speech at the end of June in which he decried the ongoing slump in production and suggested that the reform program's inflation targets be scrapped in favor of spurring an immediate recovery in output.

A second factor was Kuchma's cabinet shakeup, which promoted Roman Shpek to Deputy Prime Minister for the Economy, but demoted reform's chief architect, Viktor Pinzenik. The President also threatened to fire Central Bank Governor Yushchenko, who has implemented a tough credit policy. Kuchma missed a unique opportunity to strengthen the cabinet's commitment to reform.

Finally and most importantly, performance slipped, with money supply growing by 14% in July. Moreover, the Rada passed a third quarter budget which increased expenditures by 2% of GDP, without compensating taxes. Results were not encouraging, with monthly inflation climbing past 5% in July and the exchange rate falling by 10% during two chaotic days in the middle of August.

The Treasury Department and the IMF actively engaged Ukraine's leadership to get their economic performance back on track. The Government and IMF agreed to a revised program in August and Kuchma and his government recommitted themselves publicly to the program's stabilization goals. The Government agreed to make expenditure cuts and tax increases to put the budget back on track. Monetary targets were revised, and the Government agreed to abandon grain export quotas. The IMF Board is scheduled to approve Ukraine's standby review and allow it to access the next \$350 million tranche of its program on September 29.

Questions still remain about the Government's reform commitment and its understanding of stabilization policies. Kuchma recently restated his skepticism that the standby's inflation targets were achievable and noted his desire for the state to take a very direct and active role in boosting output. Similarly, Marchuk was even more specific in calling for new credits for industry, increased protectionism and for the state to manage trade and maintain large ownership shares in major firms. At the same time, Kuchma has implemented new tax measures and submitted a revised budget which were key preconditions for successfully concluding Ukraine's standby review, originally scheduled for mid-September. Either the leadership does not comprehend the implications of the IMF program's tight fiscal and monetary policies, which rule out new support for agriculture and industry, or it is playing domestic politics. In either case, its statements are counterproductive and erode international and domestic confidence in its economic policies.

There are concerns also about the slow pace of mass privatization. While the privatization auction apparatus is now in place, only a fraction of the privatization vouchers have been collected and minimum valuation issues at the auction often prevent firms from being successfully sold. The incentives for management and labor to privatize their firms is very low and procedures for preparing firms for the auctions remain cumbersome and expensive. Finally, the Rada has declared many agro-industry firms ineligible for privatization. Without efforts to streamline the process and a strong political push from President Kuchma and Prime Minister Marchuk, Ukraine will not even come close to reaching its goal of 8000 large and medium firms and most small firms sold by the end of the year.

## Conclusion

Ukraine faces the toughest period of its transition this year, but experience in other countries shows that continued performance will generate a sustainable recovery in the near term. It is crucial that the Government get back on track with its IMF program and regain some reform momentum. Fall and winter performance will be closely watched, as this has historically been a period of high inflation. Further progress on reducing inflation, removing remaining state controls on trade and prices and accelerating privatization are necessary for securing a critical level of stability and supporting a genuine take-off in trade and output. Recent statements supporting new state support and increased regulation in the economy only threaten important stabilization gains already achieved and will not result in increased output. Moreover, the Government needs to develop a strategic vision for its future, including steps to strengthen its economic policy institutions and to take a more active hand to accelerate and shape structural reform. The United States stands ready to offer technical assistance to support all aspects of Ukraine's reform program.

Yevhen Marchuk has a key role to play in this process. As the country's new Prime Minister with a close relationship to President Kuchma, he is uniquely positioned to push forward the actual implementation of reform policies. His own recent statements favoring slower stabilization and new state involvement in the economy are dangerous and counterproductive. His active involvement in pushing stabilization and privatization forward is crucial to reform's success.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to Vice President Gore re: Economic Reform Themes for Visit by PM Chernomyrdin (1 page)	01/26/96	P5
002. memo	Larry Summers to Secretary Rubin re: Your Meeting with President Clinton Today to Discuss Russia (1 page)	05/20/96	P5
003. memo	Robert E. Rubin to POTUS re: Meeting in Helsinki (1 page)	03/19/97	P5
004. memo	Karin Lissakers (IMF) to Larry Summers & David Lipton re: Russia & IMF (5 pages)	11/03/97	P1/b(1) <i>Unclass.</i>
005. talking points	re: RER Points for Camdessus Call on Russia (1 page)	circa April 1999	P5

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [6]

Jimmie Purvis

jp35

### RESTRICTION CODES

#### Presidential Records Act - [44 U.S.C. 2204(a)]

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RR. Document will be reviewed upon request.

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### **RER points for Camdessus call on Russia**

- 1) Russia's situation in the current international political environment is very sensitive. It is important that you understand that from the U.S. perspective it is crucial that there be no additional surprises regarding further progress toward a Russia program with the IMF.
- 2) So far we have not heard that the Fund has definitively ruled out providing funds to Russia in excess of the amounts that Russia owes the Fund during the program period.
  - Want to make clear that total disbursements under the program should not exceed Russian repayments – i.e. there should be no net transfer.
  - Also critical that the SDR mechanism for safeguarding disbursed funds be airtight.
- 3) We remain unconvinced that Russia has either the willingness or capacity to implement much in the way of real economic, financial or structural reforms under a program.
  - We view this program as primarily providing a capacity to do debt rescheduling while maintaining some level of economic stability.
  - For this reason we think that the Fund should not try to be too ambitious. Another failed program would be bad both for the IMF and its major creditors.
- 4) We are profoundly skeptical that Russia will be able to achieve the targeted 2% primary surplus. Of course, the Fund is in the best position to make this judgement, but we will have difficulty supporting a program that is not credible on its face.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Mark Sobel (IMF) to David Lipton, Tim Geithner, N. Lee, A. Baukol, and B. Cox re: Update on Russia-IMF (2 pages)	07/08/98	P1/b(1) <i>Unclass.</i>
002. memo	From Mark Sobel (IMF) re: IMF Debrief to G-7 Directors on Russia (2 pages)	08/13/98	P1/b(1) <i>Unclass.</i>
003. note	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Geithner re: Russia (1 page)	08/13/98	P1/b(1) <i>Unclass.</i>
004. briefing paper	re: Mandatory Conversion of GKOs: Russia: Preliminary Considerations (IMF document) (5 pages)	circa Aug. 1998	P1/b(1) <i>Unclass.</i>
005. briefing paper	re: Russia: Scope for Intensification of Exchange Controls (IMF document) (2 pages)	circa Aug. 1998	P1/b(1) <i>Unclass.</i>
006. memo	To the Vice President re: Policy Priorities for Russia (4 pages)	circa Oct. 1998	P5
007. briefing paper	re: Russia Strategy (5 pages)	circa Oct. 1998	P5
008. memo	To the Vice President re: Responding to Russia's Economic Crisis (6 pages)	circa Oct. 1998	P5
009. memo	Senior Deputy Assistant Secretary Truman to Rubin, Summers, & Geithner re: Principals Meeting on Russia (3 pages)	11/12/98	P5
010. memo	To the Vice President re: Russia's Economic Crisis (5 pages)	circa Oct. 1998	P5
011. memo	From Mark Sobel (IMF); For the Files re: Russia - IMF Staff Briefing to Board on Latest Mission (3 pages)	11/02/98	P1/b(1) <i>Unclass.</i>

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 241124

### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [7]

Jimmie Purvis

jp36

### RESTRICTION CODES

#### Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

#### Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
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# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
012. talking points	re: Russia - Economic Message (6 pages)	circa Dec. 1998	P5
013. memo	From Mark Sobel (IMF); For the Files re: Managing Director's Board Briefing on Russia (2 pages)	03/08/99	P1/b(1) <i>Unclass</i>

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## Russia strategy

**The current situation:** Four factors are now converging to reduce the likelihood of a sensible, resolute economic policy course in Russia:

(1) There are no good stabilization policy choices. The Russian government can no longer borrow either domestically or from non-residents, so deficit cutting is imperative. But the breakdown in the payments system and the drop in output and imports caused by the crisis itself have pushed tax and tariff revenues to perhaps half the usual inadequate levels. Opposition to further expenditure cuts and support for subsidies have intensified. The pressure for monetary emissions, to finance the current deficit, clear wage and pension arrears, and bail out the banks, is probably irresistible.

(2) The new Prime Minister Primakov has a narrow, caretaker-government mandate: to maintain political stability in Russia until the presidential elections.

(3) The increasingly urgent and widely held view is that President Yeltsin should resign (elections would then have to be held within 3 months). He is no longer an effective torch bearer for reform. Attention will increasingly be focused not on economic policy but on early presidential elections, perhaps by this spring.

(4) There is no consensus on a growth strategy and no effective political mechanism for forging one. The crisis is driving a search for a strong leader, not a convergence of views on new policies. Neither new ideas nor leaders have emerged. Russians appear to be faced with a choice between reformers who are discredited, fairly or not, and equally discredited retreads from the Gorbachev era.

As a result, we can probably expect a kind of "squeaky wheel" sequential economic policy from the Primakov government, if left to its own devices, in which it will respond more or less effectively to successive urgent problems, e.g., the collapse of the banking/payments system, food shortages, wage and pension arrears, problems in servicing external debt.

**Lessons from the transformation effort so far:** The crisis has dramatized what has been clear for some time: Russia lacks essential underpinnings of a healthy market economy: confidence in the currency as a store of value (or even as a medium of exchange for large transactions); a banking system which lends to unaffiliated private firms; a legal system which adequately protects property and investor rights; a fair regulatory and tax system which ensures a predictable, competitive, transparent business environment, effectively funds the government, and does not serve as a vehicle for state corruption.

There are at least two schools of thought as to why these have not developed in Russia. One is that it has taken a long time for them to develop anywhere, and the West, as well as Russian reformers, had unrealistic expectations about how long it would take to develop market

institutions, laws, and practices which had never existed in Russia. The other is that the United States and Western and Central Europe do not provide the right models for Russia. Asian development paths, more dependent on public-private cooperation and relationships than on law and transparency, may be more relevant.

Perhaps both are partly right. But another consideration is central for Russia. It relates to the role of the state. The irony in the aftermath of the Soviet period is that the experience of communism has heavily damaged, perhaps even destroyed, Russian people's trust in the state, their willingness to cede power to the state, and their faith in the state's ability to provide an effective social safety net. The overriding objective of business people, legislators, local officials, and individuals is to ensure protection, or at least distance, from what is perceived as the state's arbitrary, unreliable, and corrupt authority.

For this reason, it could be argued that the reform agenda aimed at bringing the unofficial barter economy into the formal, taxed and regulated sector ran directly counter to Russian peoples' perceived interests. From this perspective, it is not hard to see why it failed. It also makes it easier to understand why Russians are willing to put up with the enormous inefficiencies of a barter system as a means to avoid the greater perceived risks and costs associated with being part of the state regulated sector. The sobering lesson is that Russia faces a protracted struggle, not only to build effective state institutions but also to overcome deep-rooted resistance to the basic objective of strengthening the law-based state. We should be mindful that, as in our country's history, part of the ultimate resolution of this legitimacy issue will probably come from some redistribution of power from the center to the regions and localities.

The other lesson concerns the relative emphasis in economic policy on stabilization vs. structural reform. With hindsight it seems clear that the Russians got stuck in the stabilization phase of reform, mostly because of a failure to do the things which would have made stabilization sustainable, like fixing the tax system. Successive Russian governments struggled ineffectually with this issue, leaving little reform energy left for other challenges. The failure to do structural reform killed prospects for growth which in turn repeatedly threatened and ultimately destroyed stability. Russia and we should be careful to avoid this vicious cycle in the months ahead. Support for organic reforms should proceed with the same urgency as support for stabilization and through all means possible -- financing from international financial institutions, technical assistance, training and educational exchanges, public-private partnerships.

**Policy message to Russia:** It will be critical not to draw the wrong lessons from this crisis. The failure of Russia's economy to grow was not the result of monetary policy. Printing a lot of additional money will not induce people and businesses to invest in the real economy or even to hold more rubles (as inflation accelerates). We also conclude that the market democracy model remains the right one for Russia, but it has to be underpinned by a state which provides a competitive, orderly, predictable, and transparent environment. There is nothing cultural or uniquely Russian about the country's failure to invest and grow during the last six years.

Russian economic performance can instead be attributed to a rational response on the part of Russian people and businesses to very real policy, regulatory, and legal failures. The focus of Russia's authorities should be on correcting those failures as well as on stabilization. The U.S. and the West should strongly support these reforms with policy dialogue, financing, and



technical assistance. Moreover, if Russia moves forward resolutely to strengthen policies and the investment climate, the West should also consider ways of helping Russia tackle challenges which the market and the private sector are not suited to address.

**The reform/growth agenda and our engagement:** I would propose that the following considerations govern our message to Russia on reform and help from the West:

(1) Stabilization/exchange rate policy: The impossible fiscal bind at the moment means that stabilization will take a while. Some monetization of the deficit and of arrears clearance is inevitable. We have to be realistic about this and focus our efforts on moderating it and trying to ensure that it does not go to finance the wrong things like indiscriminate bank bailouts. The high inflation ahead has clear implications for exchange rate policy. Russian authorities seem to be moving toward trying to stabilize the ruble through restrictions on exchange market operations, trade controls and steps toward inconvertibility, and limits on access to dollar holdings and use. This is exactly the wrong direction for Russia; it will drive people deeper into barter and revive administrative controls that provide additional opportunities for corruption. We should urge a ruble float with the possibility of a renewed peg in the future as macroeconomic policy strengthens.

(2) Tax reform: The Russian government has thus far been unable to build any kind of viable coalition in support of tax reform. The only conceivable basis for doing so is to cut rates but apply them more broadly, predictably, and fairly. Moreover, the goal of reducing disincentives for new businesses to move from the informal to formal sector should be overriding. We should urge fixes to the tax system which balance three objectives: (1) raising revenues; (2) simplicity, predictability, ease of administration, and business-friendliness; and (3) broad appeal to potential constituents for tax reform. Reconciling these three objectives will likely mean lower than desirable federal revenues. The solution will probably have to come from more fiscal federalism in Russia. Some expenditures and tax authority will have to be shifted from the center to the regions/municipalities.

(3) Bank restructuring: In theory, the collapse of the banking sector provides an opportunity to rebuild a well-managed, well-regulated sector which actually lends to the real sector. Despite the weakened political position of the oligarchs (Primakov is not beholden to them), our sense is that the central bank does not have the capacity, information, or political will to avoid bailing out undeserving, even corrupt banks and allowing them to retain their old managers. But there are no Russian sources of financing for these bailouts and real concern in responsible quarters of the Russian government and central bank about the inflationary consequences of doing so through central bank credits. We should use the leverage of World Bank/EBRD financing as directly and effectively as possible here. And we should pour in as much technical assistance as can be effectively mobilized and used.

(4) Creation of a sustainable and effectively targeted social safety net and clearance of wage and pension arrears: This is probably the single most important tool for raising the Russian peoples' stake in a stronger state. Here too, we should use the tool of World Bank financing as effectively and rapidly as possible.

(5) Restructuring industry, spurring new business creation, and Marshall plan proposals: Our message should be that the right approach is a combination of fixing the policy/regulatory environment and government action to do the things that markets and the private sector can not or will not do. Subsidies and directed credits are not the right approach, they waste resources and generate inflation. There are no short cuts on the first challenge. It involves a long list of improvements to the legal and institutional framework: enforcement of sound property, contract, and bankruptcy law; the fight against corruption; strengthening the legal basis for land and housing markets; increasing labor market flexibility; elimination of burdensome firm licensing and registration requirements; and strengthening shareholder rights and enforcement, including the right to accurate and reliable disclosure of firm financial information. With regard to the second, while acknowledging the fiscal constraints on Russian government action, we should offer to engage in a constructive discussion to identify opportunities where government can usefully intervene, such as financing R&D; facilitating lending to those with no access the formal financial sector; human capital formation; building some types of infrastructure; strengthening nuclear security. Financing these efforts could come from a combination of reallocation of GOR spending, the IFIs, bilateral financing, and public/private partnerships. For those seized with the notion of a Marshall Plan for Russia, this is probably where to put the money.

(6) Increasing FDI: In the near term, as a second best policy which would have demonstration effects for the rest of the economy, the Russian government could create special, stable tax and regulatory regimes for foreign investors. Over time, these special regimes could serve as the basis for a broad-based reform of the investment regime. FDI could also be attracted by making privatization procedures more competitive and transparent.

(7) Russia's external debt obligations (Paris Club, IFIs, eurobonds, bank-to-bank external debt): Primakov appears inclined toward a non-confrontational strategy with the IFIs and foreign creditors. We should respond with a low-key, constructive strategy on Russia's Paris Club arrears/obligations, urging Russia to develop a realistic schedule of payments with rational burden-sharing among non-IFI creditors.

(8) IFI engagement: A pause in Russia's Fund program has been made unavoidable not only by Russia's policy direction but also because the Fund, fairly or not, shares the blame in Russia (not to mention Capitol Hill) for the crisis. We should urge the Fund to use this period to contemplate new, even radical, solutions to Russia's fiscal problem that have some chance of mobilizing a political consensus and being implemented. The Fund should chart a path back to stability that is gradual but sustainable. Once this path is agreed, we will have to press the World Bank to move quickly to take the lead in financing the key structural reforms outlined here. We have spoken often in the Russian context about passing the baton across 19<sup>th</sup> Street. This time it has to happen, and it has to be supported by G-7 bilateral assistance and by the EBRD.

(9) Humanitarian assistance: Whatever the reform path, the West can and should help Russia meet basic human needs. Given the very poor Russian harvest, the sharp ruble devaluation, and dried up trade finance, there will likely be food shortages and/or dramatic food prices increases in remote regions this winter putting the most vulnerable in real jeopardy. We should try hard to reach agreement with the GOR on food aid, while making a maximal effort to try to ensure that the food goes to the right people.

(10) Technical assistance: At this stage we should undertake thorough reviews of USG technical assistance effort. Effectiveness in some areas like tax reform is in doubt. I would suggest a technical assistance focus on bank restructuring, the rule of law and anti-corruption efforts, and fiscal federalism and tax administration.

# DRAFT

## Economic Message

- o Russia and the international financial community have a common objective -- creation of a viable functioning, growing Russian economy.
  - And that objective ought to be pursued in a pragmatic, non-ideological way.
- o Our discussions have revealed a broadly shared perception of much of what has gone wrong:
  - corruption and its destruction of the social contract and the investment climate;
  - arrears buildups, the culture of non-payment, and the rise of the barter economy;
  - the squandering of Russia's savings through capital flight;
  - excessive government borrowing, especially from abroad, which left Russia vulnerable to global financial turmoil and crowded out investment in the private sector; and
  - deindustrialization.
- o This common view of the challenges ought to provide the basis for Russia and the international community to come together on a program as quickly as possible.
- o But the reality is there is distrust on both sides.
  - Russia has legitimate concerns about its policies being micromanaged or being asked to adopt alien solutions.
  - The international financial community led by the IMF has legitimate concerns that Russia has a record of not living up to commitments. None of us can afford another failure, and no distinction will be made between this government and previous governments.
- o The solution is that Russia's program has to be Russian owned.
  - No IMF-supported program, even with generous levels of financing, can restore confidence if the international financial community (markets, international institutions, and governments) perceive a lack of political will to implement it.
  - This is the lesson of the Fund's experience in Indonesia earlier this year -- another case of repeated failures to implement promised reforms.
  - It is the lesson of Russia's experience this summer.
  - In Korea, the program supported by the IMF was a failure until people committed to its implementation took over. The insistence since then by Korea's President and Finance Minister that the program is Korea's, not the IMF's, has contributed enormously to its credibility.

- In the case of Brazil, the government came to the Fund, not vice versa, and worked out a coherent economic strategy over a period of several months.
- o Russia has to make choices among policy options to achieve a given set of objectives. The Fund's obligation is to give Russia accurate advice about what will work and what won't work. And the Fund at this point can only provide financial support for actual policy implementation and results, not for promises and commitments.
- o This realistic approach implies real limits on how much money can flow and how quickly it can flow.

Taking Russia's economy forward:

- o Growth is the central Russian problem and without it nothing else can work -- job creation and rising living standards, the fiscal balance, the financial system, elimination of arrears and non-payments, and establishment of a monetized economy.
- o The Russian economy suffered large blows in the last year from the halving of oil prices and Asian contagion. These would have made things very hard even in absence of other problems. But the reality is that neither Russians nor foreigners were investing much in Russia's real economy even before these blows.
- o Capital flight over the last 3 years has totaled perhaps \$10-15 billion/yr. And this does not include mattress money held as dollars by Russian citizens which has been estimated in the range of \$20-40 billion. (FYI: mattress money is separate from dollar deposits held in the banking system.) Until capital flight stops and productive investment starts, growth will not happen.
- o The second general point is that the world has changed in terms of what types of economic activities are most valued.
  - Microsoft, which didn't exist 25 years ago, is worth more than the American automobile, steel, or aerospace industries. And the information technology sector accounts for more than 1/3 of American economic growth.
  - The option of growing through resuscitating traditional heavy industry is no more available to Russia than it is to any other economy. This is even apart from the question of where the resources to subsidize these industries would come from.
  - Increases in living standards come not from production alone but from production of goods and services people want to consume.
  - In countries as diverse as China, the United States, Brazil, India, and Poland, growth and job creation have largely come from new business creation. Russia's principal need is to restructure its economy for the 21st century, not to emphasize the industries of the 19th century.

- o Russia's experience and history are unique, but it is by no means the first country to confront entrenched problems of capital flight, corruption, a weak banking system, inadequate legal protections and market institutions, and excessive government borrowing.
- o In a purely economic sense, Russia's problems have similarities with those observed in Latin America during the 1980s.
- o Latin American experience suggests that real progress, growth, and lasting benefits for ordinary people can be achieved with a coherent program that is implemented consistently. Stopping capital flight, reducing corruption, and spurring productive investment requires actions in four areas:

(1) Rationalizing government:

Tax reform in Russia has to achieve 2 objectives: (a) levels of cash tax collection by the center and the regions in line with their respective spending obligations, and (b) reasonable tax rates, predictably and uniformly applied to a broader base.

But cutting, reallocating, and controlling spending also has to remain a fundamental part of the fiscal solution. We are told that the Russian federal bureaucracy has grown by 1.2 million people in the last 6 years. Untargeted housing subsidies waste a huge share of budgetary resources. The result is not only unsustainable spending and failure to meet obligations to pensioners, teachers, and soldiers; it is also the rise of destructive, rent-seeking bureaucratic power that discourages private investment.

There is no near-term, responsible alternative to a substantial primary (non-interest) budgetary surplus. The size is a central topic in Russia's discussions with the Fund. We would simply urge that the discussion be grounded in real, achievable numbers on both the tax and spending sides. The purpose is not to reduce the deficit for its own sake but to limit excessive government borrowing that leads to monetization and accelerating inflation. The objective is stability.

(2) Fixing the banking system:

A singular feature of the development of Russia's banking system is that relatively few banks played a major role in taking deposits, in making the payments system work, and in lending to unaffiliated companies. That has not been good for the Russian economy, but it makes the job of restructuring the banking system easier because most banks were not active in the intermediation process. Few banks have a legitimate claim to be saved. This weakens the case for numerous inflationary bailouts that clearly place the interests of a few owners above the interests of the many citizens.

Your government and the central bank have so far confounded predictions of uncontrolled credit flows to banks. Urge that you remain resolute. The attention of the global financial community is focused on the hard decisions just ahead of you that appear to us to require closing banks, changing the ownership and management of those which are saved, and permitting foreign banks to help you build a vibrant banking system. These decisions will be viewed as critical indicators of who runs Russia's financial policy.

We also recognize that the challenge is not just to make the right decisions but to build the tools to implement them — the right laws, an effective bank restructuring agency, strong regulatory and supervisory capacity. Know that the World Bank, EBRD, US, EU and others are already giving you a lot of advice and technical assistance. We pledge firmly to continue to match assistance to your will and progress on bank restructuring.

Want to emphasize as well that our objective is not just to help you close banks but also to help make remaining banks effective agents for channeling Russian and foreign savings to the Russian private sector. We have consistently and strongly supported the model EBRD small and micro lending program in Russia. Its remarkable success and repayment record has been achieved through intensive efforts to combine financing with training — training of loan officers and credit managers so that they are willing to take risks because they know how to assess risk.

(3) Investment climate.— the rule of law, property rights, bankruptcy, anticorruption efforts:

It is no mystery that new business are not created in Russia, especially in the formal sector, when contracts aren't enforced, debts aren't paid, bureaucrats and others extort payments, tax authorities are arbitrary and capricious, and banks can't or won't provide financing.

There is simply no substitute for dealing with the basic legal, tax, and regulatory environment. That is the reason that Western businesses, such as those in the energy sector, have absolutely insisted on remedies such as the PSA legislation.

Want to stress that the issue is not tax holidays and preferential treatment of foreign investors. It is the establishment of a requisite degree of certainty with respect to the environment in the "formal sector" that Western businesses need in order to make investment decisions.

(4) Industrial restructuring:

Industrial restructuring requires 2 basic catalysts: (a) motivation in the form of profit-seeking or at least avoidance of bankruptcy, and (b) financing. The current Russian environment supplies neither.

In Russia's "virtual economy", managers who fail to pay taxes, wages, and other debts do not fear bankruptcy and have little incentive to seek profits, especially recorded profits. It follows that strengthened corporate governance and shareholder rights and effective bankruptcy laws and enforcement are critical.

Schemes which encourage the merging of companies under renewed state ownership without changing the incentives facing the new, larger enterprise will simply shift the burden of absorbing losses back to the state. And, as I said earlier, the objective is not just production, but production of items people want to buy.

Foreign investment, as well as restructured sound banks, can play a critical role in financing well-managed enterprises. Some have suggested that regions might compete for foreign investment, not through tax holidays, but through strengthened tax and regulatory regimes. Such investments could be facilitated by guarantees, lending, or equity stakes from international financial institutions.

The investment climate and industrial restructuring are both areas where we and others, such as the World Bank and EBRD, stand willing to offer assistance.

- o Russian progress in these 4 areas would be the basis for resumption of support from the international financial institutions. But results are crucial -- macroeconomic policy has to be firmly aimed at stability, taxes have to be collected, banks closed, anticorruption measures enforced, foreign investment attracted.
- o Want to stress our hope that you will not neglect your engagement with the World Bank on urgent growth-promoting reforms as you consult with the Fund. We very much support the goal that programs with both institutions move together in concert.
- o The largest pools of money are in private hands. Russia's eventual return to private markets is first and foremost dependent on the implementation of an economic program which assures investors that Russia's economic performance will improve and that Russia will be able to meet its debt obligations. Russia would be foolish to float more "junk bonds" now, even if it could.
- o We fully recognize that Russia's near-term external obligations greatly exceed available foreign exchange. You now face hard choices about which obligations to meet. I would add that it is our perception that a strong underlying Russian desire to honor its external debts makes these choices particularly hard.
- o As you make these choices, I would urge that three considerations guide your course.
- (1) Progress toward agreement with the IMF is critical. The scope of what official creditors can do for Russia is fundamentally and critically determined by this criterion because creditors must have some confidence that Russia can meet its obligations.



- (2) Serious and ongoing consultations with creditors, both public and private, are also crucial. Any perception that Russia is acting unilaterally, without listening and attempting to respond to the interests of creditors, is particularly harmful, and the damage will be hard to undo later. Cooperation is the name of the game.
- (3) Your decisions will be judged against the test of whether creditors, other than the international financial institutions, are treated on a comparable basis, as noted in Mr. Mayer's letter to Mr. Zadornov. The test of comparability applies both to payment and to non-payment. In this regard, your apparent intention to single out pre-1992 Soviet debt for non-payment is consequential and of considerable concern to Paris Club members

Want to stress in particular that it is impossible for the US or any other Paris Club member to defend an arrangement that treats obligations to private creditors as somehow more worthy of payment than obligations to US or other member taxpayers.

# Withdrawal/Redaction Sheet

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. outline	re: Japan, Asia, & the Yen (2 pages)	06/13/98	P5

### COLLECTION:

Clinton Administration History Project

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### FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [9]

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6/13/98

1. POTUS call to PM Hashimoto.

- Emphasizes gravity of situation, importance of early statement outlining general commitment to take additional policy actions -- to support strong and stable yen, to strengthen domestic demand, and to fix the financial system, to be followed by concrete steps post election.
- In support of a credible commitment along these lines, the President would offer to explore ways to cooperate in the exchange market to support the yen.

2. Exchange market intervention.

- U.S. initiates in New York, followed closely by Japan. (No other countries to join, at this stage.)
- Modest amount. Say U.S. \$1 billion, Japan \$2-3 billion.
- U.S. statement emphasizing seriousness of our concern for implication of a weak yen, our support for further efforts by Japan to strengthen the economy and financial system. [See attached.]

3. PM Hashimoto's statement.

- As close to current draft as possible, with following three main messages. [See attached.]
  - Strong and stable yen critical to Japan.
  - More fiscal action if necessary.
  - Clear shift in strategy in financial sector, to be implemented quickly.

This statement would be general by design, recognizing constraints imposed by election and the reality that they do not yet have a fully developed plan for the financial sector, or the consensus yet for more dramatic fiscal action.

- To follow within 12 to 24 hours of intervention.

4. Reinforcing calls to political establishment in Japan.

- Miyazawa, Takeshita, Kato, Kajiyama and Foreign Minister.
- Emphasizing importance of follow-up, post election.

5. Possible G-7 Statement

- Echoing our statement, expressing support for Japan's effort to strengthen domestic demand and the financial system, and emphasizing a commitment to cooperate in exchange markets to support the yen, as appropriate.

6. Calls to Chinese leadership, and other key Asian finance officials.

- To emphasize the depth of our concern with yen, outline our approach.

7. LHS travels to Japan, China, and then Chairs meeting of Manilla Framework Group.

- In Japan, accompanied by appropriate Fed/OCC officials, meets with range of officials and political leaders, to explore details of post election policy steps, particularly in the financial sector.
- In China, outline Japan strategy, reinforce importance of China maintaining current exchange rate stance, explore nature, degree of pressure they face to devalue.

8. Manilla Framework Meeting

- Highlight generalized concern with Japan and the yen. General statement along the lines of the G-7.
- Review state of play in rest of Asia.
- Explore new initiative to augment IFI support for social safety net, and possibly other steps.

# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. letter	From Kenneth Kizer, Under Secretary for Health; re: Claims Involving Disabilities or Death Based on Tobacco Use During Active Service (2 pages)	02/14/97	P5

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 40511

### FOLDER TITLE:

VBA History Project - Compensation & Pension - Claims Involving Tobacco Use  
During Active Service]

Jimmie Purvis

jp15

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- P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [(a)(5) of the PRA]
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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

#### Freedom of Information Act - [5 U.S.C. 552(b)]

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- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

**DEPARTMENT OF VETERANS AFFAIRS  
Veterans Health Administration  
Washington, DC 20420**

**IL 10-97-008**  
In reply refer to: 112

**February 14, 1997**

**UNDER SECRETARY FOR HEALTH'S INFORMATION LETTER  
CLAIMS INVOLVING DISABILITIES OR DEATH BASED ON  
TOBACCO USE DURING ACTIVE SERVICE**

1. This Information Letter provides new guidance for compensation and pension (C&P) examiners on claims involving the use of tobacco products while on active duty. On January 28, 1997, Veterans Benefits Administration (VBA) sent their regional offices guidance on the adjudication of claims on this subject.
2. In Department of Veterans Affairs Opinion of General Counsel Precedent (VAOPGCPREC) 2-93 dated January 13, 1993, the General Counsel (GC) addressed the issue of service connection for disabilities or death resulting from the use of tobacco products in service. The essential holdings of that lengthy opinion, for purposes of this discussion, were that tobacco use does not constitute drug abuse, for purposes of statutes barring service connection of disability or death resulting from drug abuse, and that direct service connection of disability or death may be established if the evidence shows that injury or disease resulted from tobacco use in line of duty during military, naval, or air service. During the March 4, 1993, Judicial Review Conference Call, VBA regional offices were advised to defer action on claims involving the use of tobacco products during active service and to maintain a log for control of the cases. Effective immediately, VBA regional offices have been told to pull and adjudicate all cases on that log. The Veterans Health Administration (VHA) C&P examiners should be aware that they will be receiving an increase in their workload for this reason.
2. Medical research has identified many diseases that may be potentially caused by the use of tobacco products such as cigarettes, cigars, pipe tobacco, snuff, and chewing tobacco. Disabilities that may be caused by cigarette smoking include, but are not limited to, cancer of the lung, larynx and esophagus, coronary artery disease, atherosclerotic peripheral vascular disease, emphysema, chronic bronchitis, and chronic obstructive pulmonary disease (COPD). Cancers of the cheek and gum have been potentially linked with snuff and chewing tobacco. Medical literature has also indicated a possible link between cigar and pipe smoking and cancers of the lip, tongue, larynx, and esophagus. There may be other disabilities related to the use of tobacco products.

**IL 10-97-008**

**February 14, 1997**

**3. VHA C&P examiners need to be aware that they will be requested to express an opinion on the relationship of tobacco use in service and current disability.** Review of the claims folder will be necessary. Such an opinion must be supported by factual information about, and assessment of, all pertinent issues, including the following: the relationship of tobacco use to the

specific disability claimed; the extent of tobacco use during service, as well as before and after service; the presence of other risk factors for the claimed disability and their relative importance as causal factors; the time of onset of the claimed disability; and, if applicable, the effect of cessation of smoking.

**4.** It is hoped that this information will be helpful to VA medical center staff, especially C&P examiners and their administrative staff, since the claims for these disabilities are now being processed. This information needs to be shared with all C&P examiners in order to make them aware of this new guidance and to prepare them to handle the influx of new claims.

/s/

Kenneth W. Kizer, M.D., M.P.H.  
Under Secretary for Health

DISTRIBUTION; CO: E-mailed 2/18/97

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# Withdrawal/Redaction Sheet

## Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. transcript	re: Jack Thompson's Transcript (8 pages)	ca. 1997	P5

### COLLECTION:

Clinton Administration History Project

OA/Box Number: 40511

### FOLDER TITLE:

VBA History Project - Compensation & Pension - Training Transcript for Class on Tobacco Claims

Jimmie Purvis

jpl6

### RESTRICTION CODES

#### Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [(a)(5) of the PRA]
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5-54.

## Jack Thompson's Transcript

**Jack Thompson:** I thought I'd begin this morning by talking a little bit about how the Department stumbled into this issue and contrary from some points of view it is not an issue that was necessarily the General Counsel's creation. In 1991, when the Court of Veterans Appeals in the *Sawyer* case, 1 Vet. App. 130, Judge Steinberg, in a concurring opinion, said that it was possible that the claimant could on remand establish service connection for his disability based on the 14- year history of smoking in service.

Not to long after that in 1992, a case came up to the Board of Veterans Appeals. The case involved a veteran who served from 1938 and 1945, strayed from service, and went back in 1949 and served until 1967 and then retired from the Air Force. He died of lung cancer which is why the death claim was probably based on the Jet fumes and other chemicals to which he had been exposed in service. When the case got to the Board, they got an independent medical expert opinion. Based on that expert's review of the file, he came back to the Board and said it is more likely that the veteran's 40 year history of smoking was the cause of the veteran's lung cancer. That prompted the Board to say: "Do we service connect on the basis of smoking?"

The BVA wrote out a list of questions and sent them over to General Counsel and we answered them. Really pretty simple questions when you look back at them. They asked first of all is Nicotine Dependence a disease? I am not sure why they asked the General Counsel that, but that was the first question they posed. Then they asked is smoking in service willful misconduct. They asked is it abuse of a drug. Back in 1990, Congress had precluded service connection for disabilities due to abuse of alcohol or drugs. Finally, they asked does the law permit direct service connection on the basis of smoking in service.

Well, I think they were just sort of looking for a hook because exposure to smoke versus other toxic substances in service certainly can lead to direct service connection. We told them to so in the 1993 opinion. I think it reconfirmed what they already currently do. We said whether Nicotine Dependence is a disease is really a factual question. It's not a legal question. We told them what the legal \_\_\_\_\_ since then constitutes the disease? We really want them as fact finders to make that determination.

We wrote back to them and told them what the VA regulation on willful misconduct is. We said again, we can't give you a legal opinion. We can tell you what the law says. You have to apply that law to the facts. You are the fact finder. You have to decide whether it is willful misconduct.

And then we have the history of the 1990 Act and talked about what Congress meant when it ruled off limits disabilities due to abuse of alcohol and drugs. For such drugs it is clear they meant: "A" illegal drug that you weren't even authorized under the law to use. And, number 2, legal drugs used in a way that are not intended. In other words, "abuse." Clearly, the use of a legal product such as tobacco used in its intended way is not the abuse of tobacco.

Now as we all know, if you have read the papers the last year or so, the FDA has said that nicotine is a drug and therefore, the FDA can regulate tobacco production. But, even if its a drug which it has become to be, using it is not abuse of drugs. This 1993 opinion set certain things in motion. The first discussions I had with Secretary Brown when he came on board were just a

month or two after the January 1993 opinion came out. He said, "what were you thinking when you wrote that opinion." We had a long discussion about it and he said, "That is the dumbest damn thing I ever heard of." It wasn't so much he disagreed with the opinion as with the state of the law. Veterans Benefits laws especially service connection is an extremely liberal concept. So he said, "let's write up legislation that will preclude service connecting things on the basis of their relationship to tobacco use." We worked that up and submitted it initially in 1995 to the Office of Management and Budget, it didn't clear OMB. However, in the fall of 1996 it was included as a legislative proposal when the President's budget was prepared. The President's budget request for VA was prepared and it was in the budget documents that were sent to Congress in January of this year. The formal proposal went up in a letter in May. We are on record as saying that the law as it currently exists is kind of silly. It makes the government responsible for the veteran's smoking in service and, as we discussed, in some cases even for smoking post service. This really exceeds the government's responsibility to veterans. Veterans are no more or less able to make decisions about smoking whether they should engage in it or not.

We had a House Veterans' Affairs Committee hearing earlier this year that included that Bill along with several others. There is going to be a Senate Veterans' Affairs hearing next week where it is also on the agenda. It does not appear at this point that Congress is going to act on the legislation this year. I think they're going to become more interested if the new administration testament of the potential costs and savings is prepared in the next very few weeks. I am optimistic that by next year Congress is going to get serious about this and probably in the second session of the current conference beginning in January will take a real serious look at this.

The bill as it went up would preclude service connection for post service diseases whose only relationship to service is the theoretical link to smoking in service. It makes no distinction between whether you smoke prior to 1965 when the first Surgeon General's warnings were on the packs. Congress might do something about that, they might break out into classes the eligibility of people depending upon when they did their smoking. I think certainly by next year we'll have an idea as to whether there is going to be any sort of legislative relief.

I'd like to mention though that our bill would not preclude service connection for such claims filed up until the date of enactment of the law. That really is necessary from a public policy stand point because the department, especially given the history of the difficulty that we've had dealing with this, you couldn't very well say that all the cases we've been sitting on for these many months should be denied. It would look almost as if we did delay them as being in anticipation of getting legislation. So it would be prospective only and I don't anticipate Congress would do anything else.

There was a Court of Veterans Appeals decision in 1995 that predated our recent opinions on Nicotine Dependence and I want to mention that also before I put this thing in historical prospective. We talked about the Board's decision in that case. This is a World War II veteran who served only from only 1944 to 1946. Thirty-five years later, in 1981, he was diagnosed with emphysema. The Board of Veterans' Appeals service connected that emphysema based on findings that of Nicotine Dependence from service. That dependence evidence included the letter he had written to mom back home saying he was up to a pack and a half a day smoking and said, "I know I need to cut down, but it is certainly hard, Mom." He continued to smoke and thirty-five years later chronic obstructive pulmonary disease. The Board service connected, on

the secondary basis classic of the secondary service connection we're talking about today.

That led Compensation and Pension Service to request some additional guidance from General Counsel. Is this really what the law provides for? Is this what we anticipated? Is this what we are expected to do? And, we came back and stated: "Pretty much, yes." If you establish that Nicotine Dependence is a disease, which Dr. Keiser has pretty much put to rest, that is what the fact is. If you establish that Nicotine Dependence in service was acquired in service, and it gets back in the resulting smoking led to a full service disease, then you service connect it on the secondary basis.

We wrote that opinion knowing how difficult all these questions of proof are. We realize we have the easy job. What the law says is what the law says. In most cases it is already spelled out right in the regulations, but you folks are the ones that have to deal with it. We can help in my office only to the point of saying what the law says. We don't tell you how to do it or how you are supposed to make these ridiculous \_\_\_\_\_. But that is what the law says and you have to apply the law. Frankly, until we start applying the law and awarding benefits, we are not going to get the attention of Congress to start with our legislation. To date, every question we get from them about this. Is this really a problem? Is this really going to cost a lot of money? Is there really cost avoidance to be gained from enacting such legislation because its not. Its not necessarily popular legislation that the veteran service organizations, national offices of the veteran service organizations are on record as opposing our legislation on the basis that it is just unfair. These veterans' habits were actually facilitated by the military and so VSOs are opposed to it. Congress needs a reason to enact.

There is a team working it up as best as they can an estimate of the cost of this but that is only a "swak" Until there is some actual proof of the cost, and that's the reason Compensation and Pension Service is asking you to keep good records on the statistics on the number of claims and the number of claims allowed. This is going to be kind of a hard sell. From where I sit, the legislative council as well as the legal council on this issue, I've got pretty mixed feelings. I do think public policy as affected in the law doesn't make a lot of sense. In fact, I think the more it is known to the public at large that we compensate for things such as that, the less support there is going to the program and at some point the bubble is going to burst. I agree very much with Secretary Brown that the law should be changed. Congress needs to address it. At the same token, until that happens, you need to apply the law in the same even handed and even liberal fashion as we do with respect to all other claims. That is the end of the remarks I have prepared and I am more than happy to discuss any of this among any other questions.

**Question:** I think it was significant the fact that you said in the lead case that this man from World War II got a lot of letters to his mother where he pointed out that he is addicted to nicotine. Now, I would assume in the vast majority of cases this won't be the case. Could that be for the lack of better word an "out" for establishing Nicotine Dependence? Do you agree that it would be rare that we would get in writing a statement that "I fear that my smoking is getting out of hand or something"?

**Jack Thompson:** I think probably it is rare. But, I think all that needs to be done is follow the drill that you're being given as to what well-grounds the claim and at that point we have to develop. I think it's a easier case once we've got hard documentary evidence of tobacco-use.

**Question:** I'd like to ask a question concerning the fact that we take two legal drugs, alcohol and

nicotine, and we look at them entirely at 180 degrees apart. I just wondered if part of the actual willful misconduct as it affects Nicotine Dependence may be more of a medical question than anything else. Does anybody determine whether or not you can suffice to compensate for the dependence here on 5 or 6 cigarettes a day and then for the guy who has 2 ½ packs is that willful misconduct? I mean technically speaking numerous days seven days a week for your entire life classifies as an alcoholic by some, you are probably not going to be functionally deficient or you are going to wind up to an alcoholic disease. But if you belong to a six pack or two a day, then you wind up with a willful misconduct. Has anybody ever tried to find out medically whether or not you could smoke a sufficiently low number of cigarettes, probably never came up with a disability and you shouldn't have that as willful misconduct?

**Jack Thompson:** Just think at some point the consumption reaches a point where its abuse.

**Question:** Yes. Which is what alcohol is. Exactly the way we deal with alcohol.

**Jack Thompson:** Willful misconduct, given way the current the regulation is written, I think there is some real difficult obstacles in light of the misconduct application to smoking. What the regulation said again is that conscience wrong doing, deliberate or intentional wrong doing with knowledge of or wanton and reckless disregard for the probable consequence. Probable as opposed to possible. We have some old opinions of the Solicitor in the Veterans Bureau that say it is not enough that the well-informed person would know that the conduct he is engaging in possibly could hurt him. That particular individual had to know that it was probable and more than likely than not that he was going to be harmed.

Most smokers today don't get lung cancer. Most lung cancer victims are smokers but I don't think the odd bar for most smokers is better than 50/50 that you're going to get lung cancer. We said in the 1993 opinion only what misconduct, at least under the law and regulations that we are working under today, would be very difficult and I continue to believe that. That is an issue, however, that I think the Department is going to continue to look at. Maybe more General Counsel considerations of that. More of a look as to whether the regulation is tighter than it needs to be with respect to misconduct. Is there a difference between somebody who smoked in 1964 before the Surgeon General's warning as opposed to someone who began smoking in 1966? The first warning were pretty mild. The Surgeon General said it may be hazardous to your health. By 1970, 1971 Congress stiffened up the warnings. The Surgeon General had determined that it is hazardous to your health. All of this stuff has to be rethought, but for now it is a really tough case to make.

**Question:** It seems to me that there would be a little more emphasis on that in your discussion, and the original opinion dealing with 1965, the labeling be that it may be hazardous and then it changed in 1969 to it is hazardous. Then, I heard you say that the veterans awareness of potential health consequences at the time the veteran engaged in cigarette smoking is relevant to this inquiry as to willful misconduct. It seems as if we are not really going to go there.

**Jack Thompson:** Well again, we have the easy job. We say here is what the law is, here's the things that are relevant you guys have to make the call. So, I go a little beyond what I should even say giving my opinion would be a harder case to make.

**Question:** I think probably we must have evidence that shows that it was willful intent somehow for the cause of the smoking. I think otherwise we may not be dealing with the issue of willful

misconduct.

**Jack Thompson:** This is a slippery slope. I know many situations that we don't look twice at a claim where a veteran was playing flag football in service. You don't think twice about that game for willful misconduct so think about it. When I played touch football in service, I knew there was a good chance of getting my ankle stepped on or to step in a hole. Was it probable? It's really kind of the same situation. I see it as a legal activity, yet I knew there was some risk. I mean how different is it. Can they put a little warning on the football.

**Question:** How we deal with words, should they have known, could they have found out. Warning labels on alcohol have only recently been done. It takes one abuse that for 25-30 years we actually recognized and printed a warning on and we take another one which we never printed a warning on. On the one we never printed a warning and it becomes willful misconduct. Kind of interesting.

**Jack Thompson:** The question is that maybe smoking is not quite the same as abusing drugs. But we are saying for sort of the same public policy reasons, VA should not be in that business.

**Question:** It is kind of a cultural thing here, we've known forever that alcohol turns you into a loser and can kill you. This thing has just come along recently that smoking causes problems. Yet, culturally we are living with the abuses.

**Jack Thompson:** There are still a lot of parallels for alcohol. On the face of it, there was the Officer's Club and rations in the field that included cigarettes. [tape is garbled and rest of comments can not be heard]

**Question:** The GC opinion is going to be published in the Federal Register. Is there going to be a public comment period?

**Jack Thompson:** No. The reason it will be published in the Federal Register is that it puts the public on notice that it is the GC's interpretation of the law. If a GC opinion would be harmful to someone and would restrict benefits, you can't use the opinion against somebody until it has been published in the Federal Register. Technically, the public is on notice that that is the way VA views the law. This is an interpretative rule as to this is what the law is.

**Question:** There must surely be a term proximate from a legal stand point that is clear as to what proximate cause is. Could you embellish on that for us?

**Jack Thompson:** I was trying to think of an example on the train coming up here. Take it this way. Nicotine Dependence in service causes emphysema five years later. Because of my emphysema and my difficulty breathing, I want to move to Arizona. The plane I am taking to Arizona, due to the negligence of the airline, crashes. Nicotine Dependence is no longer the proximate cause. Its to remote and not proximate to my death. In other words, there is a supervening intervening cause.

**Question:** If you get an opinion from a medical examiner about the Nicotine Dependence and its associated with smoking, cause of lung cancer, that is proximate enough for your purpose?

**Jack Thompson:** I really don't think you can worry to much about proximate, just think in

terms of cause. Did it cause and don't get to hung up over proximate. It is enough that a doctor says that tobacco use is a cause of the disease.

**Question:** So, when they say possible or that Nicotine Dependence is related to that, that's really not proximate. If it is possible Nicotine Dependence is related to that, we really don't gather cause for it.

**Jack Thompson:** Proximate cause has to be an indispensable part of the chain of causation. Without it, the injury was not an occurrence. So, if somebody says, it is only possible that it caused, then you have a possible proximate cause you don't have a real proximate cause.

**Question:** Then how would you argue that the death was not the proximate cause in your example of the airplane crash. That is he would not have been on that plane if it had not been for that disability. How would you argue that that was not the proximate cause?

**Jack Thompson:** Well, what you argue is that Nicotine Dependence did cause my emphysema. Clearly, it is the proximate cause of my emphysema. However, I could have lived a ripe old age with that emphysema with good medical care. It was not an indispensable part of the plane crash. The plane crash would have occurred whether I had gone to Arizona to visit grandma.

**Question:** I have a Doctor's statement that said he went to Arizona, for alleviation of his illness.

**Jack Thompson:** Even that, if it had not been for the negligence of the airlines, I would have landed safely.

**Question:** I am looking at paragraph 17 that you add to the opinion as they were stating that in order for the tobacco smoking to constitute willful misconduct in a particular case, the evidence must establish that the smoking involved deliberate or intentional wrong doing and that either the veteran knew or did intend the health consequences of smoking or that the veteran's smoking was wanton and reckless disregard of the probable consequences. If the evidence shows otherwise, I guess we go by the concept that we don't judge the law, we just apply it. You know if the evidence doesn't show that willful misconduct was shown in the veteran involved in his smoking and that it involved deliberate or intended wrong doing, then we won't even consider willful misconduct.

**Jack Thompson:** The key phrase again, is with "disregard or probable consequences." That's a tough verdict.

**Question:** You mentioned proximate cause is an indispensable part. Can we be still be talking about lung cancer as a beginning at this point, I think, in terms of proximate cause. But, we're going to have far more cases of arteriosclerotic heart disease in which there are 6 to 8 major risk factors depending on whose books you read of which smoking is always one of them. There is a problem with horror factor or something about hardening of the arteries 25 or 30 years ago. Lots of people who don't smoke get arteriosclerotic heart There are very few people who don't smoke get lung cancer. That's part of the medical nexus that has to be established by the doctor.

**Jack Thompson:** If the doctor tells you that but for the smoking this heart disease would not of occurred, then you've got proximate cause clearly and the standard is "likely as not." That is kind of a double negative but I think that is the best way of putting it.

**Question:** In other words, there still has to be a nexus?

**Question:** Is it more than likely that our medical opinion would say something to the effect of the combination of the hereditary, the smoking and eating habits all contributed and its impossible to weigh?

**Jack Thompson:** Unless they are saying that take away the lung disease and it wouldn't have happened. I don't know whether you could get you refined now how this question should be posed to the examiner.

**Question:** I take it you've got a private medical opinion offered to well ground a claim that the connection is there and you've got the VA examiner who says he doesn't know whether it is there or not than you still would be in favor in granting.

**Question:** The most important thing, I have heard so far, is that nothing is going to change in the law until Congress realizes the impact. The only way they are going to realize that, is by granting. The other thing is, obviously, we are working here consistently. We've got the Board of Veterans Appeals and we've got COVA superimposed on top of Board of Veterans Appeals. If unwarranted denials find their way up to that Court than we need to get some clearer rules on what constitutes acceptable proof, and, it may not be ones the Department is going to like.

**Jack Thompson:** I think, unless these claims are decided in the same even handed way, with the same objective way that you decide other claims, we could get our heads handed to us because the Court knows that we are on record with Congress as wanting the law changed. So, they are going to be looking for signs that we are resistant to applying current law in an even handed way. So, from where I am standing, if we go out to deny cases it will be seen as trying to evade the dictates of the law. We're going to be in trouble. We'll get case law on this, and likely it will not be what we expect or want.

**Question:** Given that same analysis though, and the lack of legislation and case law to be pending, don't you see that as a slippery slope with just Nicotine Dependence in and of itself. It seems to me that's the vehicle to get the secondary service connection. But, with the trend in society right now which is virtually a smoke free environment that's becoming in turn, in more and more places, and the inability to smoke may have adverse consequences on people. They say I have Nicotine Dependence that was caused in service. Can't you see that giving use to other disabilities both psychological and physical. It seems that you want to deal with quick and of course its going to get worse, and worse, and worse.

**Jack Thompson:** I guess I don't disagree. When I first came in a while ago, I heard talking about when you service connect Nicotine Dependence by itself. Suppose the person doesn't have lung cancer or anything else attributed to it. He wants to be on record as having Nicotine Dependence. You should listen to the advice you're getting from Compensation and Pension Service. I would just say that historically, General Counsel has a been of the view that if there is no disability. Disability is different than a disease. You can have a disease that causes mental disability. If you have only a disease incurred in service that is not in anyway disabling, in my view, you don't service connect it. We service connect just the disabilities but that is not to say that its not important to first determine that it is not a secondary service connection case. At issue as to whether that Nicotine Dependence caused emphysema. The regulation (3.310) says if

a disability is proximate, and leads to a permanent connected disease. Notice, it doesn't say the term "disability." Now, by that it means a disease incurred or aggravated in service. I think you find, and I am no expert on this, that if you find that the person is Nicotine Dependent by itself, is disabling to a degree. Like you said, the guy can't keep a job because they won't let him go outside every 20 minutes. If it is disabling then you should service connect it. For my money's worth if you do have a claim for service connection for Nicotine Dependence and that's it, I might be inclined to say, depending on the facts, that there is no current disability.

**Question:** We have been told that Congress isn't really to interested until they really know the impact. Would you elaborate. Are there other reactions from Congress or they feel pressured from veterans groups or the politics of it as to why they don't want to pass it?

**Jack Thompson:** Let just tell you why they passed so far this year. Primarily it is part of the budget process. The Committee have already been allocated how much money they can devote to the VA's budget for the following fiscal year. Back in the end of May they reported to their budget or appropriation's committee, legislation that would keep them under what their allocated amount is. So, they've met their budgetary goal for this year. They don't really need to find savings for the rest of this session. Now, that's totally apart from whether its good public policy for them to act now and reap the savings later and they have more available to spend on something than they might have to fork over.

**Question:** Don't they have some idea of how much this will cost? Are they taking it to consideration?

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**Jack Thompson:** It's one thing to say the government is responsible for your smoking in service, it's another thing to say yes by god we're responsible for your post-service smoking too. That is a big jump. If you would like to know when we sent the bill up this year, one of the reasons, OMB scored it because it wasn't determined whether it is cost or savings. They scored it basically as net "0" because they thought that most of the people would compensate based on direct service connection would be military retirees. They were in service long enough so that smoking was probably so much bigger than post-service we would probably be service connecting a lot of those cases. So in the absence of any other intelligence as to what kind of cases, we would be primarily service connecting the military retiree. Well, think about it. A military retiree can retire today and there would be an offset. They would waive their retired pay to get our compensation. It would be sort of a wash. That was the way they initially viewed this, so when we sent our package up there in May with all its flourish and press releases, and everything else, and said, "By the way, we can't promise you any savings." Well, that was pre May 1997 when the Nicotine Dependence opinion was issued. We now need attention with respect to that. We realize now that we're talking about potentially, when you start talking about heart disease in an aging veterans population, we're talking real money. Congress is going to act, I don't see how they can ignore it once that becomes evident. Okay, thank you.



# WITHDRAWAL SHEET

## Clinton Library

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**File Folder: Domestic Policy Council – Documentary Annex II    Date: Oct. 26, 2004**

DOCUMENT NO. & TYPE	SUBJECT/TITLE	DATE	RESTRICTION
1. Memo	Bruce Reed & Elena Kagan to Chief of Staff re: Tobacco Negotiations, 8pp.	5/10/98	P5
2. Memo	Bruce Reed & Elena Kagan to POTUS re: Tobacco Negotiations Status Report, 4pp.	5/12/98	P5
3. Memo	Bruce Reed & Elena Kagan to POTUS & VPOTUS re: Federal Tobacco Claims, 2pp.	9/30/98	P5

### RESTRICTIONS

**P1** National security classified information [(a)(1) of the PRA].

**P2** Relating to appointment to Federal office [(a)(2) of the PRA].

**P3** Release would violate a Federal statute [(a)(3) of the PRA].

**P4** Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA].

**P5** Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA].

**P6** Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA].

**PRM** Personal records misfile defined in accordance with 44 USC 2201 (3).

**B1** National security classified information [(b)(1) of the FOIA].

**B2** Release could disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA].

**B3** Release would violate a Federal statute [(b)(3) of the FOIA].

**B4** Release would disclose trade secrets or confidential commercial financial information [(b)(4) of the FOIA].

**B6** Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA].

**B7** Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA].

**B8** Release would disclose information concerning the regulation of financial institutions [(b)(9) of the FOIA].

**B9** Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA].

THE WHITE HOUSE  
WASHINGTON

May 10, 1998

MEMORANDUM FOR THE CHIEF OF STAFF

FROM: Bruce Reed  
Elena Kagan

SUBJECT: Tobacco Negotiations

This memorandum reviews what we need to get out of our negotiations with Senators McCain and Hollings; what we can give up; and some ideas on opening positions and trades. Negotiations are not scheduled to begin until Tuesday, so we can meet Monday to discuss these ideas and any other questions you might have. We also would like to go over spending issues, including the public health programs and the state menu; OMB is currently preparing some tables for this discussion.

I. What we need

A. Lookback Penalties (pp. 345-61).

The most important (and most difficult) concession we need to secure in these discussions is to strengthen the lookback penalties by increasing the cap and adding a company-by-company component. Along with liability, this is the number-one concern for Conrad, Waxman, and many public health advocates. But Hollings and the industry will vehemently resist any increase in penalties as a backdoor way to drive up the price of a bill they think costs too much already. McCain might have given us these changes in committee, but Hollings said no.

In its current form, the McCain bill includes industrywide penalties of up to \$3.6 billion, the precise equivalent of a 20% miss. Instead of a company-specific penalty, the McCain bill includes a provision that could theoretically deny liability protection to a company that missed the targets by more than 20% -- but in its current form the provision is meaningless.

In an earlier memo, we described three options on how to meet our concerns: (1) raise the cap to \$4-5 billion, and add a company-specific penalty of \$500 per youth smoker; (2) raise the cap to \$4-5 billion, and add a company-specific penalty of \$20 million per percentage point (the virtual equivalent of \$500 per youth smoker); or (3) raise the cap to \$5 billion, with companies paying the first \$4 billion on the basis of adult market share and the last \$1 billion on the basis of youth market share. These are the options you described to McCain in your office. We offered to explain these options in more detail to John Raidt, but he has yet to take us up on it.

We now think we have an even better idea that stacks these approaches in a way that might sound more attractive to the public health community but also fits more neatly into the current McCain bill. Here's how it would work: The first 20% would be paid industrywide, as in McCain. Once the industry-wide level was reached, any company that missed by more than 20% would be assessed an uncapped company-specific penalty of \$500 for each youth smoker beyond the 20% miss. Under this scheme, there is no cap on penalties - just an industrywide tier for the first 20% and a company-specific tier beyond 20%. But because the company-specific component is reasonable, and doesn't kick in until 20%, there's no need for a cap because it won't put anybody out of business. Treasury estimates that even if youth smoking didn't decline at all, and companies had to pay for a 60% miss in year 10, Philip Morris would pay a company-specific penalty of less than \$500 million.

Waxman will never be satisfied with these amounts, and whatever we get will suffer by comparison to the Meehan-Hansen bill, with over \$1.00 a pack in company-specific penalties. But being able to say we have penalties that are uncapped with a company-specific component will go a long way with the rest of the public health crowd. Moreover, it only requires one change in the McCain bill: replacing the current unworkable company-specific provision linking a 20% miss to liability protection with our company-specific idea. We might be able to convince Hollings that such a trade isn't so bad from the industry's standpoint. (The public health community doesn't seem to care about the current provision, but industry analysts were somewhat alarmed by it.)

To end up with this plan, we recommend staking out an opening bargaining position that is somewhat stronger: for example, raising the industry cap to \$5 billion, and adding an uncapped company-specific penalty of \$500 for every youth smoker (not just the ones above a 20% miss). (We could start at \$750, although that is more than we discussed with McCain.) Another idea we could raise to frighten Hollings (and eventually relent on) is the prospect of seeking to strengthen the link between a 20% miss and loss of liability protection.

#### **B. Environmental Tobacco Smoke (ETS) (pp. 415-20).**

The McCain bill generally requires owners of "public facilities" (defined as any building "regularly entered by 10 or more individuals at least one day per week") to prohibit smoking except in specially designated smoking areas that accord with specified ventilation requirements. The bill excludes from this general prohibition buildings used for residential purposes and -- in the so-called hospitality exception -- buildings used as a "restaurant (other than a fast food restaurant), bar, private club, hotel guest room or common area, casino, bingo parlor, tobacconist's shop, or prison." The bill further provides -- in the so-called opt-out clause -- that none of the ETS provisions shall apply to any state that "by law, provides that [they] shall not apply to that State."

Our goal is to remove the opt-out clause, which the agencies (OSHA, EPA, HHS) and the public health community agree very substantially diminishes the value of an otherwise fairly

strong ETS provision. The tobacco industry does not much care about this section of the bill; the original June 20th settlement did not include any state opt-out, instead simply setting a national standard. For some Republicans, however, the issue is ideological; the opt-out clause is a way of resisting federal (worse yet, OSHA) regulation. We should not underestimate how difficult it will be to remove this provision -- but we also should not underestimate the importance of this issue to the public health community and the need for us to come out with a solid win.

The agencies and public health community also would like us to fight the breadth of the hospitality exception -- particularly its coverage of non-fast food restaurants and casinos, which are often the most unhealthy of all public facilities; the agencies have suggested phasing in (over a period of five or so years) the application of the bill's ETS provisions to these facilities. Subjecting restaurants and casinos to the bill's ETS provisions, however, would add yet another set of powerful interest groups to the many already fighting tobacco legislation. If ~~we~~ were to succeed in accomplishing this objective, we might soon regret it.

In thinking about the ETS issue, you should note that the Chafee-Harkin bill adopts a very different approach, which is much more amenable to Republicans. Rather than prescribing a national standard for public facilities, Chafee-Harkin would provide grants to states and building owners for progressively lowering exposure levels. At the same time, Chafee-Harkin would provide funds for outreach and education regarding the health effects of ETS on children, which primarily occurs in their own homes. Some of the agencies think that a program of this kind, assuming adequate funding, could have substantial health benefits; EPA in particular is very supportive of the focus on children, and would like us to press for funds for this purpose wholly independent of the public facility standard. The public health community, however, is focused on a national standard and will give us little credit on the ETS issue unless we emerge with the standard currently in the McCain legislation minus the opt-out provision.

In light of all the above, we recommend an opening position that demands both the removal of the opt-out clause and the elimination or narrowing of the hospitality exception. We can then bargain down solely to the removal of the opt-out clause. We would not initially mention the use of incentive grants, because McCain is likely to jump on that suggestion as an alternative to a national standard. At an appropriate time, however, we may want to suggest the addition of a grant program to a national standard, so as to make it less of an unfunded mandate. If such a funding stream becomes part of the ETS provisions, we should try to include some grants for outreach and education relating to ETS's effects on children.

### C. Antitrust Exemption (pp. 628-29).

The McCain bill exempts from the antitrust laws any concerted action among tobacco manufacturers if it is for purposes of (1) entering into and complying with the agreements (protocols, consent decrees, etc.) presumed to exist between the manufacturers and the federal and state governments; (2) refusing to deal with a distributor or retailer who offers products to underage persons or otherwise fails to comply with the requirements of the law; and (3) carrying

out any plan to reduce the use of tobacco products by teens if the Attorney General has determined that the plan is "appropriate as part of the effort to reduce the use of tobacco products by underage individuals and will not have the effect of unduly restraining competition."

The Antitrust Division hates antitrust exemptions, and this one is no exception. The Division worries that any antitrust exemption, no matter how carefully drafted, will tend to facilitate anticompetitive behavior in an industry, including price-fixing. In response to the argument that anticompetitive behavior will only increase prices, which is what we want with regard to tobacco products, the Division notes that it does so by allowing the tobacco companies to unduly enrich themselves, which is hardly the mechanism most consistent with public health interests. Moreover, the Division believes that the McCain bill is not carefully drafted; rather than specifying clearly and precisely what kinds of concerted action tobacco manufacturers can undertake in what circumstances, the bill countenances concerted action of any kind whenever intended to facilitate several generally defined purposes. (With regard to lack of specificity, provision (1) above is particularly troubling.) Finally, the Division objects strenuously to the regulatory role assigned to the Attorney General by the McCain bill, noting that (1) she has no expertise in determining what efforts will reduce youth smoking and (2) the involvement of law enforcement officers in policy matters of this kind would set an unfortunate precedent.

Although the Division's general inclination is to oppose any and all antitrust exemptions, it also acknowledges that in limited circumstances, an agreement among tobacco manufacturers could facilitate efforts to reduce youth smoking without imposing any real harm. (The Division believes that the strongest case for an antitrust exemption is in a bill without company-specific lookback penalties, because such a bill has little way of containing free-riding other than by facilitating industry-wide agreements.) The Department is accordingly drafting a carefully limited exemption that we could substitute for the McCain language. We should have this new language on Monday.

We recommend an opening position that calls for the elimination of the antitrust exemption. We may not encounter much resistance to this position. If we do, we should revert to the Antitrust Division's new language. The difference between eliminating the provision and substituting our own language is not worth terribly much -- to our own agencies, to the public health community, or to Democratic members of Congress.

#### **D. Liability Issues (pp. 431-51).**

In addition to the annual liability cap, the McCain bill contains a number of less high-profile liability provisions that Sen. Conrad has been trying to highlight. The bill settles not only the state suits (as the Conrad bill itself does), but also the so-called "Castano suits" -- i.e., the class actions brought by Stan Chesley and others alleging the harm of addiction (not tobacco-related disease) and requesting a remedy of cessation services (not compensatory damages). The bill also bars suits by cities or counties located in states that have recovered funds under the Act. Perhaps most important, the bill prevents plaintiffs with tobacco-related claims from suing any

entity other than the tobacco manufacturer, including parents and affiliates, officers and directors, and other persons involved in the distribution chain (e.g., distributors, wholesalers, retailers). Finally, the bill provides that in claims against manufacturers, evidence relating to reduced risk products developed after enactment of the legislation shall be neither admissible nor discoverable.

We should insist, as an initial matter, that liability limitations go only to companies that "return to the table" -- i.e., companies that sign a protocol with the federal government agreeing to abide by the bill's terms, as well as the additional, otherwise unconstitutional advertising restrictions. As you recall, we have given McCain's staff a set of changes designed to make the bill work regardless whether the companies agree to participate. In this set of changes, we put the liability protections into the portion of the bill -- and only into the portion of the bill -- that applies to willing parties (so-called participating manufacturers). We have reason to believe that McCain agrees with this structure, but do not know Hollings' views. If we need to, we should insist on the point: a company should not get liability protections if it has not agreed to accept the bill's terms without challenge and to adopt additional advertising restrictions.

As to the content of the liability protections, we want to have another conversation with Conrad's staff, but we are inclined to think that you should raise only the issue of parent and affiliate liability. The Justice Department largely supports the rationale of the other provisions: the Castano plaintiffs, like the states, were well-represented at the bargaining table, and the funds for cessation in the bill represent recovery for their claims; the preemption of local claims where a state already has collected funds prevents double recovery; the protection of entities down the distribution chain encourages companies to deal with participating manufacturers and effectively prevents them from challenging the bill's advertising provisions; and the reduced risk rule encourages the development of safer products. The Department has some suggested changes to the language in these provisions, but we suspect we can make these changes on the staff level. The single liability limit that seems troubling in concept -- and to which Conrad has most strongly objected -- is the protection of parents and affiliates of manufacturers, which would protect these entities from tobacco-related suit even when they have committed an independent wrong. Bruce Lindsey agrees that we should be able to remove this provision.

## II. What we can give away

### **A. Volume Adjustment.**

The most valuable concession we can make in these discussions is to allow the annual payments to be adjusted for volume in the first five years (the current volume adjustment doesn't begin until after year 6). This change would give the industry the certainty of knowing that the annual payments won't increase cigarette prices by more than \$1.10 a pack, even if volume plunges. It could also reduce available revenue in the 5-year budget window by \$5-10 billion. But it is a concession we almost certainly have to make in order to keep Joint Tax from scoring the McCain bill as an increase of \$2 a pack. (Joint Tax is currently assuming higher retail

markups and other factors that will keep the price around \$1.50 even with a volume adjustment.)

In the first five years, the McCain bill provides for fixed payments by tobacco manufacturers of \$93 billion (plus a \$10 billion voluntary upfront payment). We estimate that these payment levels will reduce consumption by 23% and result in an effective real price increase of \$1.10 per pack by 2003. Beginning in 2005, the McCain bill would adjust these payments as consumption rises or falls, thereby keeping the per pack cost constant.

The industry and Wall Street were quick to criticize this approach as a death spiral, because the companies would still have to pay \$93 billion over 5 years even though they expect consumption to drop nearly twice as fast as we projected. Our \$1.10 is based on consumption at 17.7 billion packs in 2003. If consumption fell to 13 million packs, as many analysts predict, that would rise to \$1.50. The industry also argues that at those prices, black market sales would significantly reduce legal consumption, driving the price of the settlement per pack higher still.

The major drawback of a volume adjustment is that instead of locking in \$65 billion over 5 years, we'll end up with somewhat less. Joint Tax is likely to assume a larger drop in consumption than Treasury, so with fewer packs sold, \$1.10 a pack will bring in less money. (We've asked OMB and Treasury to prepare a memo for you on where they think Joint Tax will come out, based on our meeting last week.)

We propose a volume adjustment that begins in year 2, and would be based on the difference in the prior year between actual volume and our estimated levels (essentially, a correction of our previously estimated volume adjustment). This approach will keep the price per pack constant at \$1.10, while keeping projected industry payments as close as possible to our budget numbers.

#### **B. International Provisions (pp. 583-7, 599-628).**

The McCain bill currently contains a number of provisions on international tobacco control proposed by Sen. Wyden. The bill would broaden the current prohibition (the "Doggett provision") on using federal funds to promote tobacco products in such a way as to interfere with the government's ability to negotiate general tariff reductions. The bill also would impose the marketing, advertising, and labeling restrictions applying in this country to U.S. companies, or their affiliates or subsidiaries, operating overseas. Finally, the bill would impose a clearly unconstitutional 2-cent per-pack export fee.

Everyone in the room will dislike these provisions. McCain thinks they're silly; Hollings thinks they're detestable; and our own agencies object to everything noted above except the requirement that U.S. tobacco companies operating abroad use the same or substantially similar labels (most already do). As you know from listening to Rep. Pelosi, however, these provisions are very popular among liberal Democrats, elite opinion-makers, and the public health community. They believe that without these provisions, this legislation may simply export our



tobacco problem to other nations.

Our bargaining position with respect to this issue is hardly optimal, because McCain and Hollings know our own opinion of these provisions. But in light of who supports these provisions, we cannot give them up without getting something substantial for them. Indeed, even if we do effect a good exchange, we may want to keep this part of the bargain out of the text of the manager's amendment. McCain's staff has suggested, for their own reasons, that the best way to deal with this issue may be through a pre-rigged floor amendment (i.e., an amendment we would agree to support). Although this approach forces us to reveal our view of the international provisions, it also insulates us from the charge that we have given away these provisions in what could be characterized as a backroom negotiation.

### C. Attorneys' Fees Limitations (pp. 451-54).

The McCain bill has one provision relating to attorney's fees. This provision submits to arbitration, to the extent consistent with private agreements, any fee dispute arising from "litigation affected by, or legal services that . . . resulted in, this Act" -- i.e., the state suits and the Castano actions. Under the provision, the arbitration panel makes an award to the lawyer after considering criteria such as the time the case required, the difficulty it involved, and the risk it imposed on the attorney. This provision is exactly what the lawyers in these cases want; it does nothing for the many Republicans who would like to limit fee awards.

One way to respond to this desire is to impose an presumptive cap of \$250 per hour on the awards that the arbitration panel could make. Under this provision, the arbitration panel could decide that the circumstances were sufficiently unusual as to call for more than \$250 per hour, but generally would make awards within the cap. Such a provision would substantially (i.e., by millions and millions of dollars) cut into the awards of the Castano and state lawyers, to the extent that their preexisting contracts do not specify other fee arrangements. (The Justice Department believes that attorneys for only 15 states -- the four that have already settled and 11 others -- have contractual rights that could trump such a statutory provision; we do not know about the lawyers for the Castano plaintiffs.)

We do not know whether McCain will raise the issue of attorneys fees; he does not seem to care much about it personally, but to the extent he is negotiating for his Caucus, he might well do so. If he does, we should offer the above proposal; even if he does not, we should probably look for an opportunity to suggest a trade involving this kind of provision. McCain might want to go further, imposing still more stringent limits on the lawyers in the state and Castano suits, or imposing limits on the lawyers in any tobacco legislation, now or in the future. We should not accept the latter kind of proposal in this negotiation, because our own caucus (including Sen. Hollings) would view it as pro-tobacco, anti-trial lawyers, and anti-consumers.



### Smaller Issues and Trades

We are meeting with McCain's and Hollings' staff on Monday morning to discuss a number of design issues that we hope can be resolved without the principals. These include (1) how much to charge smokeless manufacturers; (2) how to structure the \$6.5 billion liability fund; (3) licensing and anti-smuggling provisions; (4) document disclosure provisions; (5) inflation adjustments and other technical pricing issues; (6) whether and how to reduce the 17 so-called new federal bureaucracies; (7) whether and how to provide funds for asbestosis victims; and (8) how to restructure the bill to make it effective regardless whether the companies return to the table. If we need to bump any of these issues up to the principals' level, we will let you know quickly.

Assuming the issues for the principals are as stated above, we think the following trade-offs make some sense: (1) strengthened lookbacks in exchange for a volume adjustment and elimination of the provision to remove liability caps; (2) strengthened ETS provision in exchange for amendment of the international provisions; (3) elimination of the antitrust exemption and parent company protection in exchange for attorneys' fees limitations; and (4) as we will discuss further tomorrow, full funding for public health programs and a good state menu in exchange for our agreement to no new entitlement spending.

THE WHITE HOUSE  
WASHINGTON

May 12, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Bruce Reed  
Elena Kagan

SUBJECT: Tobacco Negotiations Status Report

Erskine, Larry, and we held a series of meetings today in an attempt to reach agreement with Sen. McCain on a manager's amendment to his tobacco bill. Although we have not yet nailed down a deal with McCain, our discussions with him were very fruitful. In later discussions, Sen. Daschle indicated real enthusiasm for the deal that we believe we can make. As explained further below, however, Sen. Conrad expressed severe disappointment on several issues.

The key features of the manager's amendment under discussion are as follows:

1. Price. As you know, the McCain bill imposes payments of about \$65 billion over the next five years. OMB has calculated that these payments, when passed on to price, will increase the price of a pack of cigarettes by \$1.10. We expect, however, that CBO will say tomorrow that if the McCain bill becomes law, the price of a pack of cigarettes will rise by over \$2 in the next five years. A large part of this price differential reflects disparate assumptions about how much the volume of cigarettes sold will decline in this period. (The more consumption declines, the larger the per-pack price increase necessary to make the annual industry payments.)

To combat the new CBO figures, which will tend to support the industry's recent arguments, we would agree in the manager's amendment to incorporate an explicit "volume adjustment" in the first five years of the McCain bill. (There is already an explicit volume adjustment after year six; prior to this point, OMB's estimates about volume reduction were taken into account in setting the annual payments, but there is no correction mechanism if OMB is wrong.) This volume adjustment would ensure that the price increase attributable to the annual industry payments would not exceed \$1.10 per pack, no matter how much volume declines. (CBO assumptions regarding additional factors, such as wholesale and retail mark-ups and state excise tax increases, should bring the total price increase to about \$1.50 in five years.) The downside of this approach is that if CBO is right about how steeply consumption will fall, a volume adjustment will bring down the total revenue generated by the bill -- OMB estimates by between \$5 and \$10 billion in the first five years.

Sen. Conrad is worried that if we go this route, we will wind up with far less revenue than is necessary to fund what people expect from a tobacco bill. It is unclear, however, what Sen.

Conrad would do to respond to the forthcoming CBO estimates. He seems to want to insist on an \$1.50 per pack excise tax, but CBO would score that as above \$2 as well, rendering this approach utterly impractical.

2. Lookbacks. As you recall, the McCain bill has industry-wide lookback penalties capped at approximately \$3.5 billion per year, with no company-specific penalties at all. We have gotten McCain and Hollings to agree to raise the cap on industry-wide penalties to \$4 billion. We have also gotten them to add a company-specific penalty wholly outside the cap of \$1000 per child for every child by which the company misses its youth smoking targets. This figure represents twice the lifetime profits that a company earns from any youth smoker. Finally, we have gotten McCain and Hollings to agree to strengthen the provision linking a 20 percent miss to the loss of liability protection. Under the current provision, when a company misses by more than 20 percent, the government must show that a company committed affirmative misconduct in order to trigger the loss of liability provisions. Under the new provision, when a company misses by this amount, the tobacco company will have to show both that it did not engage in affirmative misconduct and that it used best efforts to reduce youth smoking in order to escape the loss of liability protections.

Sen. Daschle was supportive of this agreement, but Sen. Conrad thought the provision on company-specific lookbacks is weak. His own proposal would impose far more onerous company-specific penalties, perhaps as much as ten or twenty times higher. We believe penalties of this magnitude would ensure that the companies never return to the bargaining table; we also could not possibly convince McCain and Hollings to accept company-specific penalties of this magnitude.

3. Liability. As you recall, the McCain bill provides for an annual liability cap of \$6.5 billion, while avoiding the question of whether this money comes from the annual industry payments or from other industry assets. McCain has now agreed to push the liability cap to \$8 billion, the exact amount of the Harkin-Chafee liability cap. (As you recall, you said you would sign Harkin-Chafee.) We have tentatively agreed that (1) half of the upfront payment that the industry makes will go to pay legal judgments and (2) when that amount is depleted, half the amount of judgments will come from the annual payments and half from other assets of the liable company(ies).

Another, perhaps even more tricky set of issues has arisen around other liability provisions in McCain. First, the legislation provides that suits for tobacco related disease can be brought only against a tobacco product manufacturer, and not against a wide variety of other parties, including their parents and affiliates; officers, directors, employees, agents, or attorneys; importers, distributors, wholesalers, and retailers; suppliers of component or constituent parts; growers; and insurers. We have succeeded in removing this liability protection for parents and affiliates. We do not think anyone cares about removing protection for growers, suppliers, or parties down the distribution chain. Conrad, however, has objected strongly to giving liability protection to attorneys, and we are trying to remove this provision. We may also try to remove

the protection for officers, directors, employees, agents, and insurers.

Second, the McCain bill settles the Castano lawsuits, which are lawsuits brought on behalf of addicted (but not ill) persons for cessation services. We have succeeded in ensuring that the language in the bill does not at all affect the ability of plaintiffs claiming injury from disease to use evidence of addiction in their lawsuit. (Evidence of addiction generally would come in to these suits in response to the industry's charge that the plaintiff chose to smoke and thus assumed the risk of injury.) As currently written, however, the bill does bar all future claims based solely on addiction. The rationale for this provision is that the legislation itself provides funds for cessation services -- the exact remedy that addicted (but not ill) persons seek. Conrad, however, wants to continue to allow these claims in the future. We do not believe this result can be accomplished while settling the Castano lawsuits, which many Senators would like to do.

Third, the McCain bill provides that no evidence relating to reduced-risk tobacco products is admissible in suits alleging harm from tobacco-related disease. The rationale for this provision, which is very similar to one of the federal rules of evidence, is to assure manufacturers that their development of safer products will not come back to haunt them in a legal proceeding. We have succeeded in narrowing this provision somewhat (so that such evidence, although not admissible at trial, will be discoverable), but apparently not enough for Conrad. We intend to take another run at this provision tomorrow, not because we think Conrad is right, but because we think the liability cap will be easier to maintain if we remove as many objections to other liability protections as possible.

4. Second-Hand Smoke. As you recall, the current McCain bill has a strong environmental tobacco smoke (ETS) provision, but gives states the opportunity to opt out of it entirely. We have tentatively agreed to maintain the opportunity for an opt-out, but only if the state is able to demonstrate to OSHA that it has an ETS standard at least as protective of public health as the federal standard. This compromise, if it holds up, should get us all we need on this issue.

5. International. We think that Sens. McCain, Hollings, and Wyden have agreed to eliminate many of the international provisions in the current McCain bill. (Wyden was their original sponsor.) Under this agreement, the manager's amendment would eliminate the 2 cents per pack export fee, eliminate extraterritorial restrictions on advertising and marketing, and eliminate restrictions on tobacco products in duty-free stores and on military bases. The provisions would continue to fund international tobacco control efforts and would establish a mechanism for multi-lateral negotiations on tobacco marketing and advertising.

6. Spending. We have yet to have a full discussion of spending with McCain, but we believe we can convince him to divide money among (1) the states, (2) public health money (cessation, prevention, counteradvertising, etc.), (3) health research, and (4) farmers. We doubt we can convince McCain to earmark any of the state money to the specific programs we proposed in our budget -- child care and class size reduction. We think, however, that he will

agree that states must use a portion of their money (representing the federal government's share of Medicaid recoveries) on programs appearing on a specified menu. We are currently developing an agreed-upon menu with the NGA; we hope it will include between 8 and 12 health and children's programs, including child care and class size reduction.

7. Bureaucracies. As you know, the industry and other opponents of the McCain legislation have accused it of setting up 17 new federal "bureaucracies." (Charts purporting to illustrate the legislation -- similar to those used in the health care debate -- are appearing all over.) We succeeded today in eliminating all of these 17 supposed bureaucracies, leaving a stripped-down, much simpler bill.

8. Farmers. We agreed to give Sen. Hollings help in ensuring passage of the LEAF Act. Hollings is worried that he will lose a vote on the floor to substitute Sen. Lugar's farming plan for his own. As you know, Lugar's plan would buy out all tobacco farmers and then end the tobacco price support system; Hollings's plan would compensate tobacco farmers for any loss suffered as a result of legislation (through buyouts and/or subsidies), while keeping the price support system in place.

Please let us know if you have any thoughts on, or objections to, what we are doing in these negotiations.

THE WHITE HOUSE  
WASHINGTON

September 30, 1998

MEMORANDUM FOR THE PRESIDENT AND VICE PRESIDENT

FROM: Bruce Reed  
Elena Kagan

SUBJECT: Federal Tobacco Claims

Over the last few months, we and Bruce Lindsey have had many conversations with Department of Justice attorneys regarding the feasibility of bringing suit against the tobacco companies for Medicare and other losses stemming from the use of tobacco products. We also have asked DOJ lawyers to consult with a number of law professors and trial attorneys who have considered the viability of a lawsuit.

The Department now has concluded that it should not bring suit against the companies. Almost everyone at DOJ agrees that such a suit could be brought consistent with Rule 11 (i.e., with minimum professional standards). Most DOJ lawyers also acknowledge that given the size of the claim and other factors, the companies might well choose to settle the suit (as they are settling state claims) for a substantial sum of money plus public health concessions. DOJ attorneys believe, however, that they should not bring suit unless they would stand a reasonable prospect of actually winning the suit at trial and on appeal (i.e., putting aside all settlement possibilities). The attorneys have concluded that under existing law governing Medicare and other potential federal claims, they cannot meet this standard. The lawyers principally argue that current law precludes the federal government from aggregating (i.e., bringing in a single suit) claims for each Medicare beneficiary's tobacco-related health care costs.

At the same time, most DOJ attorneys appear amenable to settling federal claims against the tobacco companies without bringing a prior lawsuit. (The lawyers reason that although they cannot bring suit against the companies for want of an effective aggregation device, they do in fact have millions of individual claims against the companies, which they could settle all at once.) Under this approach, the government would enter into negotiations with the tobacco companies to resolve potential federal claims; if an agreement were reached, the parties would file in court a settlement agreement and proposed consent decree, which would release federal claims against the tobacco companies in exchange for some combination of monetary damages and injunctive relief. No legislation would be necessary.

We have some reason to believe that the companies -- at least Philip Morris and Lorillard -- would have an interest in entering into this kind of negotiation in the wake of a settlement with the states (which, as you know, is rumored to be in the offing). The principal outside counsel for Philip Morris (Meyer Koplow) recently suggested to Elena that his client wants to resolve all

government claims against it, including potential claims by the federal government. He implied that a potential settlement agreement could include money, FDA jurisdiction, and marketing restrictions.

The prospects of actually reaching a good agreement with the companies are uncertain. We know that the companies want to rid themselves of potential government litigation, primarily so they can spin off non-tobacco assets. But without an actual suit against the companies, we would have relatively little leverage in negotiations. Moreover, we could encounter serious legal difficulties in trying to achieve some of our objectives -- particularly, an assurance of FDA jurisdiction -- through a non-legislated settlement.

We believe the Administration should attempt to engage the companies in such a negotiation, but we wanted your approval first. There is always some risk that Democrats will fret that we are letting the companies off too easily. However, they will be reassured somewhat by the Justice Department's involvement in these negotiations -- and the only relief the companies can get out of these talks is from a suit we have not brought. The advantage of entering into negotiation is that we might be able to get something done on tobacco without Congress -- and if not, we could lay the groundwork for legislative action next year.

Approve: \_\_\_\_\_

Disapprove: \_\_\_\_\_

Let's Discuss: \_\_\_\_\_